

REDWOOD TRUST INC  
Form 10-Q  
November 07, 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: September 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

(I.R.S. Employer

Incorporation or Organization)

Identification No.)

**One Belvedere Place, Suite 300**

**Mill Valley, California**  
(Address of Principal Executive Offices)

**94941**  
(Zip Code)

**(415) 389-7373**

(Registrant's Telephone Number, Including Area Code)

**Not Applicable**

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

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

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

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

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

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

Common Stock, \$0.01 par value per share

82,394,379 shares outstanding as of November 4,  
2013



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**2013 FORM 10-Q REPORT**  
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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****REDWOOD TRUST, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Share Data)**

<b>(Unaudited)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
<b>ASSETS</b>		
Residential loans, held-for-sale (includes \$727,278 and \$556,283 at fair value)	\$ 727,879	\$ 562,658
Residential loans, held-for-investment	1,864,653	2,272,812
Commercial loans, held-for-sale (includes \$27,413 and \$0 at fair value)	27,413	8,500
Commercial loans, held-for-investment	352,440	304,510
Real estate securities, at fair value	1,324,678	1,108,753
Mortgage servicing rights, at fair value	60,234	5,315
Cash and cash equivalents	204,646	81,080
<b>Total earning assets</b>	<b>4,561,943</b>	<b>4,343,628</b>
Restricted cash	417	383
Accrued interest receivable	14,523	12,442
Derivative assets	4,852	2,972
Deferred securities issuance costs	14,694	9,293
Other assets	63,087	75,380
<b>Total Assets <sup>(1)</sup></b>	<b>\$ 4,659,516</b>	<b>\$ 4,444,098</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Liabilities</b>		
Short-term debt	\$ 838,299	\$ 551,918
Accrued interest payable	11,162	4,592
Derivative liabilities	32,697	51,081
Accrued expenses and other liabilities	36,918	26,902
Asset-backed securities issued	2,061,665	2,529,941
Long-term debt	471,605	139,500
<b>Total liabilities <sup>(1)</sup></b>	<b>3,452,346</b>	<b>3,303,934</b>
<b>Equity</b>		

Common stock, par value \$0.01 per share, 180,000,000 and 165,000,000 shares authorized; 82,388,502 and 81,716,416 issued and outstanding		824		817
Additional paid-in capital		1,757,680		1,744,554
Accumulated other comprehensive income		114,768		138,332
Cumulative earnings		781,164		633,052
Cumulative distributions to stockholders		(1,447,266)		(1,376,591)
<b>Total equity</b>		<b>1,207,170</b>		<b>1,140,164</b>
<b>Total Liabilities and Equity</b>	\$	<b>4,659,516</b>	\$	<b>4,444,098</b>

(1) Our consolidated balance sheets include assets of consolidated variable interest entities ( VIEs ) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At September 30, 2013 and December 31, 2012, assets of consolidated VIEs totaled \$2,419,786 and \$2,901,214, respectively, and liabilities of consolidated VIEs totaled \$2,063,758 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) Three Months Ended September 30, Nine Months Ended September 30,

(Unaudited)	2013	2012	2013	2012
<b>Interest Income</b>				
Residential loans	\$ 17,027	\$ 20,419	\$ 53,497	\$ 65,041
Commercial loans	10,740	7,482	30,534	18,363
Real estate securities	29,649	31,805	84,480	94,532
Cash and cash equivalents	4	17	153	52
Total interest income	57,420	59,723	168,664	177,988
<b>Interest Expense</b>				
Short-term debt	(5,227)	(2,737)	(13,721)	(6,863)
Asset-backed securities issued	(9,712)	(23,171)	(31,022)	(73,827)
Long-term debt	(6,894)	(2,377)	(16,908)	(7,132)
Total interest expense	(21,833)	(28,285)	(61,651)	(87,822)
<b>Net Interest Income</b>	35,587	31,438	107,013	90,166
Provision for loan losses	(1,727)	(1,319)	(493)	(254)
Other market valuation adjustments	462	2,164	(4,433)	1,440
Other-than-temporary impairments <sup>(1)</sup>	-	(1,207)	(1,666)	(1,842)
Other market valuation adjustments, net	462	957	(6,099)	(402)
<b>Net Interest Income After Provision and Other Market Valuation Adjustments</b>	34,322	31,076	100,421	89,510
Mortgage banking activities, net	(5,944)	12,303	98,608	13,642
Operating expenses	(21,853)	(17,102)	(65,095)	(46,900)
Realized gains, net	10,469	13,940	23,291	34,555
Net income before provision for income taxes	16,994	40,217	157,225	90,807
Benefit from (provision for) income taxes	4,935	(516)	(9,113)	(1,116)
<b>Net Income Attributable to Redwood Trust, Inc.</b>	\$ 21,929	\$ 39,701	\$ 148,112	\$ 89,691
Basic earnings per common share	\$ 0.26	\$ 0.48	\$ 1.76	\$ 1.10



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Diluted earnings per common share	\$	0.25	\$	0.48	\$	1.65	\$	1.09
Regular dividends declared per common share	\$	0.28	\$	0.25	\$	0.84	\$	0.75
Basic weighted average shares outstanding		82,201,473		79,685,099		81,888,231		78,908,057
Diluted weighted average shares outstanding		84,422,039		80,764,380		93,233,865		80,175,660

(1) For the three months ended September 30, 2013, there were no other-than-temporary impairments. For the three months ended September 30, 2012, other-than-temporary impairments were \$1,580 of which \$373 were recognized in Accumulated Other Comprehensive Income. For the nine months ended September 30, 2013, other-than-temporary impairments were \$1,666, none of which were recognized in Accumulated Other Comprehensive Income. For the nine months ended September 30, 2012, other-than-temporary impairments were \$2,472, of which \$630 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**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
(Unaudited)	2013	2012	2013	2012
<b>Net Income</b>	\$ 21,929	\$ 39,701	\$ 148,112	\$ 89,691
Other comprehensive (loss) income:				
Net unrealized (loss) gain on available-for-sale securities	(633)	41,392	(29,615)	83,467
Reclassification of unrealized (gain) loss to net income	(6,962)	796	(19,211)	1,210
Net unrealized gain (loss) on interest rate agreements	4,018	2,346	25,043	(914)
Reclassification of unrealized loss on interest rate agreements to net income	62	1,126	219	3,260
<b>Total other comprehensive (loss) income</b>	<b>(3,515)</b>	<b>45,660</b>	<b>(23,564)</b>	<b>87,023</b>
<b>Comprehensive Income Attributable to Redwood Trust, Inc.</b>	<b>\$ 18,414</b>	<b>\$ 85,361</b>	<b>\$ 124,548</b>	<b>\$ 176,714</b>

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

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

For the Nine Months Ended September 30, 2013

s, Except Share Data)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	
	Shares	Amount					
<b>2012</b>	81,716,416	\$ 817	\$ 1,744,554	\$ 138,332	\$ 633,052	\$ (1,376,591)	\$
	-	-	-	-	148,112	-	
ensive (loss) income	-	-	-	(23,564)	-	-	
<b>Common stock:</b>							
vestment & stock	374,371	4	7,073	-	-	-	
ck purchase and	297,715	3	(5,390)	-	-	-	
ty award compensation	-	-	11,443	-	-	-	
ends declared	-	-	-	-	-	(70,675)	
<b>2013</b>	82,388,502	\$ 824	\$ 1,757,680	\$ 114,768	\$ 781,164	\$ (1,447,266)	\$

Months Ended September 30, 2012

s, Except Share Data)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	
	Shares	Amount					
<b>2011</b>	78,555,908	\$ 786	\$ 1,697,979	\$ (13,151)	\$ 501,283	\$ (1,294,313)	\$
	-	-	-	-	89,691	-	
ensive income	-	-	-	87,023	-	-	
<b>Common stock:</b>							
vestment & stock	2,609,151	26	36,398	-	-	-	
ck purchase and	361,262	3	(1,905)	-	-	-	
ty award compensation	-	-	7,369	-	-	-	
ends declared	-	-	-	-	-	(61,337)	
<b>2012</b>	81,526,321	\$ 815	\$ 1,739,841	\$ 73,872	\$ 590,974	\$ (1,355,650)	\$

*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**

<b>(In Thousands) (Unaudited)</b>	<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>Cash Flows From Operating Activities:</b>		
Net income attributable to Redwood Trust, Inc.	\$ 148,112	\$ 89,691
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(18,060)	(18,045)
Depreciation and amortization of non-financial assets	310	1,727
Purchases of loans	(6,864,921)	(1,522,949)
Proceeds from sales of loans	6,254,382	1,051,778
Principal payments on loans	9,467	7,438
Net settlements of derivatives	55,694	(20,376)
Provision for loan losses	493	254
Non-cash equity award compensation	11,443	7,369
Market valuation adjustments, net	(76,425)	4,489
Realized gains, net	(34,322)	(52,003)
Net change in:		
Accrued interest receivable, deferred tax assets, and other assets	2,374	5,538
Accrued interest payable and accrued expenses and other liabilities	17,378	26,458
Net cash used in operating activities	(494,075)	(418,631)
<b>Cash Flows From Investing Activities:</b>		
Purchases of loans held-for-investment	(63,071)	(135,662)
Proceeds from sales of loans <sup>(1)</sup>	440	357,742
Principal payments on loans	415,576	425,344
Purchases of real estate securities	(142,628)	(338,058)
Proceeds from sales of real estate securities	213,139	172,265
Principal payments on real estate securities	124,030	173,849
Proceeds from deconsolidation	-	6,386
Purchase of mortgage servicing rights	(3,106)	-
Net increase in restricted cash	(34)	(27,600)
Net cash provided by investing activities	544,346	634,266
<b>Cash Flows From Financing Activities:</b>		
Proceeds from borrowings on short-term debt	5,745,892	1,043,767
Repayments on short-term debt	(5,459,511)	(949,609)
Proceeds from issuance of asset-backed securities	-	2,445

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Repayments on asset-backed securities issued	(465,986)	(491,134)
Deferred securities issuance costs	(9,184)	-
Proceeds from issuance of long-term debt	332,119	-
Repayments on long-term debt	(14)	-
Net settlements of derivatives	(9)	(20,047)
Net proceeds from issuance of common stock	6,452	34,698
Taxes paid on equity award distributions	(5,789)	(2,210)
Dividends paid	(70,675)	(61,337)
<b>Net cash provided by (used in) financing activities</b>	<b>73,295</b>	<b>(443,427)</b>
Net increase (decrease) in cash and cash equivalents	123,566	(227,792)
Cash and cash equivalents at beginning of period	81,080	267,176
Cash and cash equivalents at end of period	\$ 204,646	\$ 39,384

**Supplemental Cash Flow Information:**

Cash paid during the period for:

Interest	\$ 60,394	\$ 89,727
Taxes	3,397	225

**Supplemental Noncash Information:**

Real estate securities retained from whole loan securitizations	\$ 379,174	\$ 107,219
Retention of mortgage servicing rights from whole loan securitizations	41,128	3,849
Transfers from residential loans to real estate owned	3,448	4,825

(1) For the nine months ended September 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**

**September 30, 2013**

**(Unaudited)**

**Note 1. Redwood Trust**

Redwood Trust, Inc., together with its subsidiaries ( Redwood, we, or us ), is an internally-managed specialty finance 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. For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust ( REIT ).

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 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 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 September 30, 2013 and December 31, 2012, and for the three and nine months ended September 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. Certain 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.

***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 res securitization transaction we engaged



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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

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

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

*Fair Value Measurements*

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

obtain include the following:

Quoted prices for the same or similar securities;

Relevant reports issued by analysts and rating agencies;

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

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

Indicative prices or yields from broker/dealers; and,

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

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

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

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 Fair Value

We have established policies to elect the fair value option for residential and commercial loans that we purchase with the intent to sell to third parties or transfer to Sequoia securitizations. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net for residential and commercial loans held at fair value.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

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

**Residential and Commercial Loans Lower of Cost or Fair Value**

Certain residential and commercial loans, acquired prior to our fair value option policy elections, are carried at the lower of their cost or fair value. 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. 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 status. Gains or losses on the sale of residential or commercial loans held-for-sale are based on the specific identification method for loans measured on an individual basis or in aggregate for those loans measured on a pool basis.

*Residential and Commercial Loans Held-for-Investment*

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

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

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

securitization trust and decide to subsequently sell the underlying loans to third parties.

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

*Residential Loans Allowance for Loan Losses*

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

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

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

Historical loss rates and past performance of similar loans;

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

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**(Unaudited)**

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

Trends in delinquencies and charge-offs;

Effects and changes in credit concentrations;

Information supporting a borrower's ability to meet obligations;

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

Discounted cash flow analyses.

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



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

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

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

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

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 estimated fair market value of the loan, with a corresponding charge to provision for loan losses on our consolidated statements of income.

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

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

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

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

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

*Repurchase Reserves*

We 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

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**(Unaudited)**

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

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

*Trading Securities*

We primarily denote trading securities as those securities where we have adopted the fair value option. Trading securities 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 interest only ( IO ) securities designated as trading securities are reported in mortgage banking activities, net, a component of our consolidated statements of income. Changes in the fair value of other trading securities are reported through our consolidated statements of income in other market valuation adjustments, net.

*Available-for-Sale Securities*

AFS securities 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.

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**(Unaudited)**

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

***MSRs***

We recognize MSRs through the acquisition of mortgage 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 associated with our MSRs. MSRs are initially recognized and carried at their estimated fair values. Changes in the estimated 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.

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

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.

*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.



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

***Deferred Securities Issuance Costs***

Securities issuance costs are expenses associated with the issuance of long-term debt, and the ABS issued from the Residential Resecuritization, the Commercial Securitization, and Sequoia securitization entities we sponsor and consolidate for financial reporting purposes. These expenses typically include underwriting, rating agency, legal, accounting, and other fees. ABS issuance costs associated with liabilities 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.

***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.

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

*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.

*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.

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

***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 consolidated statements of 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.

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.

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

*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.

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.



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## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

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

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

*Offsetting of Financial Assets, Liabilities, and Collateral*

September 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 <sup>(1)</sup> Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
<b>Assets <sup>(2)</sup></b>						
Interest rate agreements	\$ 4,107	\$ -	\$ 4,107	\$ (3,851)	\$ (212)	\$ 44
CBAs	745	-	745	(745)	-	-
Futures	-	-	-	-	-	-
<b>Total Assets</b>	<b>\$ 4,852</b>	<b>\$ -</b>	<b>\$ 4,852</b>	<b>\$ (4,596)</b>	<b>\$ (212)</b>	<b>\$ 44</b>
<b>Liabilities <sup>(2)</sup></b>						
Interest rate agreements	\$ (26,356)	\$ -	\$ (26,356)	\$ 3,851	\$ 22,505	\$ -
CBAs	(5,810)	-	(5,810)	745	4,726	(339)
Futures	(531)	-	(531)	-	531	-
Loan warehouse debt	(461,584)	-	(461,584)	461,584	-	-
Security repurchase	(371,201)	-	(371,201)	371,201	-	-



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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

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

(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 sheets.

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 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, manager, or depositor 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 September 30, 2013*

<b>September 30, 2013 (Dollars in Thousands)</b>	<b>Sequoia Entities</b>	<b>Residential Resecuritization</b>	<b>Commercial Securitization</b>	<b>Total</b>
Residential loans, held-for-investment	\$ 1,864,653	\$ -	\$ -	\$ 1,864,653
Commercial loans, held-for-investment	-	-	269,255	269,255
Real estate securities, at fair value	-	275,763	-	275,763
Restricted cash	159	-	138	297
Accrued interest receivable	3,061	682	1,933	5,676
Other assets	4,050	-	92	4,142
<b>Total Assets</b>	<b>\$ 1,871,923</b>	<b>\$ 276,445</b>	<b>\$ 271,418</b>	<b>\$ 2,419,786</b>
Accrued interest payable	\$ 1,322	\$ 27	\$ 744	\$ 2,093
Asset-backed securities issued	1,790,687	112,179	158,799	2,061,665
<b>Total Liabilities</b>	<b>\$ 1,792,009</b>	<b>\$ 112,206</b>	<b>\$ 159,543</b>	<b>\$ 2,063,758</b>
<b>Number of VIEs</b>	<b>24</b>	<b>1</b>	<b>1</b>	<b>26</b>

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

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

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 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 nine months ended September 30, 2013, we transferred residential loans to 17 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 September 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 nine months ended September 30, 2013 and 2012.

***Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood***

<b>(In Thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Principal balance of loans transferred	\$ 1,210,604	\$ 313,226	\$ 5,253,314	\$ 1,350,082
Trading securities retained, at fair value	8,702	5,139	100,552	31,925
AFS securities retained, at fair value	71,527	18,576	278,622	75,293
Gains on sale	-	4,023	-	15,632
MSRs recognized	12,514	1,241	41,128	3,849

Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSR (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 nine months ended September 30, 2013 and 2012.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 4. Principles of Consolidation (continued)***Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood*

<b>(In Thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Cash proceeds	\$ 507,202	\$ 299,582	\$ 4,366,556	\$ 1,271,655
MSR fees received	3,160	260	6,235	414
Funding of compensating interest	(152)	(27)	(415)	(43)
Cash flows received on retained securities	15,656	2,333	30,606	5,432

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

*MSR Assumptions Related to Unconsolidated VIEs Sponsored by Redwood*

<b>At Date of Securitization</b>	<b>Issued During</b>			
	<b>Three Months Ended September 30, 2013</b>		<b>Nine Months Ended September 30, 2012</b>	
Prepayment speeds	5 - 8 %	5 - 28 %	5 - 13 %	5 - 23 %
Discount rates	12 %	12 %	12 %	10 %

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

*Unconsolidated VIEs Sponsored by Redwood*

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
On-balance sheet assets, at fair value:		
Interest-only securities, classified as trading	\$ 117,443	\$ 10,409

Subordinate securities, classified as AFS	386,266	113,681
Maximum loss exposure <sup>(1)</sup>	503,709	124,090
Principal balance of loans outstanding	6,414,120	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 September 30, 2013 and December 31, 2012.



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## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

## Note 4. Principles of Consolidation (continued)

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

## September 30, 2013

(Dollars in Thousands)	MSRs	Senior Interest-only Securities	Subordinate Securities
Fair value at September 30, 2013	\$ 56,244	\$ 117,443	\$ 386,266
Expected life (in years) <sup>(1)</sup>	8	6	13
Prepayment speed assumption (annual CPR) <sup>(1)</sup>	9 %	12 %	13 %
Decrease in fair value from:			
10% adverse change	\$ 1,905	\$ 6,192	\$ 930
25% adverse change	4,498	31,332	2,198
Discount rate assumption <sup>(1)</sup>	11 %	5 %	6 %
Decrease in fair value from:			
100 basis point increase	\$ 2,407	\$ 5,668	\$ 34,680
200 basis point increase	6,876	10,851	64,546
Credit loss assumption <sup>(1)</sup>	N/A	0.23 %	0.23 %
Decrease in fair value from:			
10% higher losses	N/A	\$ 61	\$ 1,268
25% higher losses	N/A	154	3,169

## 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 life (in years) <sup>(1)</sup>	3	3	10
Prepayment speed assumption (annual CPR) <sup>(1)</sup>	33 %	29 %	24 %
Decrease in fair value from:			

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10% adverse change	\$	351	\$	724	\$	858
25% adverse change		812		1,674		1,909
Discount rate assumption <sup>(1)</sup>		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 <sup>(1)</sup>		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

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

***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.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 4. Principles of Consolidation (continued)***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 September 30, 2013, grouped by collateral type and ownership interest.

*Third-Party VIE Summary***September 30, 2013**

<b>(Dollars in Thousands)</b>	<b>Fair Value</b>
Residential real estate securities at Redwood	
Senior	\$ 288,963
Re-REMIC	156,346
Subordinate	99,897
<b>Total Investments in Third-Party Real Estate Securities</b>	<b>\$ 545,206</b>

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 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.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(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 September 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>September 30, 2013</b>		<b>December 31, 2012</b>	
	<b>Carrying Value</b>	<b>Fair Value</b>	<b>Carrying Value</b>	<b>Fair Value</b>
<b>Assets</b>				
Residential loans, held-for-sale				
At fair value	\$ 726,161	\$ 726,161	\$ 553,576	\$ 553,576
At lower of cost or fair value	1,718	1,794	9,082	9,324
Residential loans, held-for-investment	1,864,653	1,690,898	2,272,812	2,062,352
Commercial loans, held-for-sale				
At fair value	27,413	27,413	-	-
At lower of cost or fair value	-	-	8,500	8,500
Commercial loans, held-for-investment	352,440	357,077	304,510	309,547
Trading securities	130,854	130,854	33,172	33,172
Available-for-sale securities	1,193,824	1,193,824	1,075,581	1,075,581
Mortgage servicing rights	60,234	60,234	5,315	5,315
Cash and cash equivalents	204,646	204,646	81,080	81,080
Restricted cash	417	417	383	383
Accrued interest receivable	14,523	14,523	12,442	12,442
Derivative assets	4,852	4,852	2,972	2,972

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REO <sup>(1)</sup>	4,050	4,728	4,245	5,540
Margin receivable <sup>(1)</sup>	46,970	46,970	63,424	63,424
Other collateral posted <sup>(1)</sup>	5,000	5,000	-	-
<b>Liabilities</b>				
Short-term debt	\$ 838,299	\$ 838,299	\$ 551,918	\$ 551,918
Accrued interest payable	11,162	11,162	4,592	4,592
Derivative liabilities	32,697	32,697	51,081	51,081
ABS issued	2,061,665	1,853,161	2,529,941	2,372,971
Commercial borrowings	44,605	44,605	-	-
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 \$9 million and \$101 million of residential senior securities, \$4 million and \$4 million of residential subordinate securities and \$1.28 billion and \$6.35 billion of residential loans (principal balance) that we acquired during the three and nine months ended September 30, 2013, respectively. We also elected the fair value option for \$113 million and \$263 million of commercial senior loans we acquired during the three and nine months ended September 30, 2013, respectively. We anticipate electing the fair value option for residential senior IO 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.

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 September 30, 2013, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

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## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

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

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

September 30, 2013 (In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
<b>Assets</b>				
Residential loans, at fair value	\$ 726,161	\$ -	\$ -	\$ 726,161
Commercial loans, at fair value	27,413	-	-	27,413
Trading securities	130,854	-	-	130,854
Available-for-sale securities	1,193,824	-	-	1,193,824
MSRs	60,234	-	-	60,234
Derivative assets	4,852	745	4,107	-
<b>Liabilities</b>				
Derivative liabilities	32,697	6,341	26,356	-

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

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

(In Thousands)	Residential Loans	Commercial Loans	Assets Trading Securities	AFS Securities	MSRs
Beginning balance - December 31, 2012	\$ 553,576	\$ 0	\$ 33,172	\$ 1,075,581	\$ 5,315
Principal paydowns	(6,675) (40,307)	(109) 2,818	(1,240) 34,380	(122,789) 45,824	- 9,628

(Losses) gains in net income, net					
Unrealized losses in OCI, net	-	-	-	(48,823)	-
Acquisitions	6,448,724	262,806	104,552	417,251	45,291
Sales	(6,228,242)	(238,102)	(40,010)	(173,220)	-
Other settlements, net	(915)	-	-	-	-

**Ending Balance  
- September 30,  
2013**

\$	726,161	\$	27,413	\$	130,854	\$	1,193,824	\$	60,234
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The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at September 30, 2013 and 2012. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and nine months ended September 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 September 30, 2013 and 2012 Included in Net Income***

(In Thousands)	Included in Net Income			
	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
<b>Assets</b>				
Residential loans, at fair value	\$ (1,864)	\$ 11,662	\$ (3,088)	\$ 11,662
Commercial loans, at fair value	831	11	831	134
Trading securities	(1,525)	28,937	28,491	71,136
Available-for-sale securities	-	(1,207)	(940)	(1,842)
MSRs	1,344	(578)	12,561	(1,029)
<b>Liabilities</b>				
Derivative liabilities	-	(2,304)	-	(3,394)
ABS issued - Acacia	-	(28,167)	-	(73,193)



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## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

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

The following table presents information on assets recorded at fair value on a non-recurring basis at September 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 September 30, 2013.

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

September 30, 2013 (In Thousands)	Carrying Value	Fair Value Measurements Using			Gain (Loss) for	
		Level 1	Level 2	Level 3	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013
<b>Assets</b>						
Residential loans, at lower of cost or fair value	\$ 1,116	\$ -	\$ -	\$ 1,116	\$ (13)	\$ 29
REO	1,305	-	-	1,305	30	(367)

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

*Market Valuation Adjustments, Net*

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>Other</b>				
Residential loans, at lower of cost or fair value	\$ (11)	\$ 90	\$ 68	\$ 572
Commercial loans, at fair value	-	11	-	134
Trading securities	540	35,099	(4,168)	84,923
	-	(1,207)	(1,666)	(1,842)

<b>Impairments on AFS securities</b>				
REO	(76)	(220)	(407)	(364)
Other derivative instruments, net	9	(4,649)	74	(10,632)
ABS issued Acacia	-	(28,167)	-	(73,193)
<b>Total other</b>	<b>462</b>	<b>957</b>	<b>(6,099)</b>	<b>(402)</b>
<b>Mortgage banking activities</b>				
Residential loans, at fair value	(10,804)	14,976	(17,339)	14,992
Commercial loans, at fair value	3,171	-	2,826	-
Trading securities	(1,866)	(4,427)	36,399	(9,101)
MSRs	460	(650)	9,629	(1,194)
Derivative instruments, net	442	(2,385)	51,009	(8,784)
<b>Total mortgage banking activities</b>	<b>(8,597)</b>	<b>7,514</b>	<b>82,524</b>	<b>(4,087)</b>
<b>Total Market Valuation Adjustments, Net</b>				
	\$ (8,135)	\$ 8,471	\$ 76,425	\$ (4,489)

**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.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)***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.

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

*Fair Value Methodology for Level 3 Financial Instruments***September 30, 2013**

<b>(Dollars in Thousands)</b>	<b>Fair Value</b>	<b>Unobservable Input</b>	<b>Range</b>	<b>Weighted Average</b>
<b>Assets</b>				
Residential loans, at fair value:				
Loans priced to securitization	\$ 230,465	Discount rate	4 - 4 %	4 %
		Prepayment rate	15 -15 %	15 %
		Default rate	1 - 1 %	1 %
		Loss severity	22 - 22 %	22 %
		Credit support	8 - 8 %	8 %
Loans priced to whole loan market and committed to sell	401,009	Pool fallout assumption	0 - 0 %	- %

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Loans priced to whole loan market and uncommitted to sell	94,688	Base Price	101.5 - 101.5 %	101.5 %
		Base Coupon	3.2 - 4.1 %	3.9 %
		Buy up (x coupon difference from base coupon)	2 - 2 x	2 x
		Buy Down (x coupon difference from base coupon)	3 - 3 x	3 x
Residential loans, at lower of cost or fair value	1,116	Loss severity	15-28 %	21 %
Commercial loans, held for sale	27,413	Credit Spread	161 bps - 161 bps	161 bps
		Credit Support	20 - 20 %	20 %
Trading and AFS securities	1,324,678	Discount rate	5 - 13 %	7 %
		Prepayment speed	1 - 40 %	13 %
		Default rate	0 - 35 %	8 %
		Loss severity	20 - 66 %	32 %
		Credit support	0 - 61 %	5 %
MSRs	60,234	Discount rate	9 - 11 %	11 %
		Prepayment rate	6 - 60 %	9 %
REO	1,305	Historical loss adjustment	0 - 40 %	15 %

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

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

*Determination of Fair Value*

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

*Residential loans*

Estimated fair values for residential loans are determined based on either an exit price to securitization or the whole loan market. For loans valued based on an exit to securitization, significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the limited availability of market quotes on newly issued Residential Mortgage-Backed Securities ( 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).

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 estimated 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 Commercial Mortgage-Backed Securities ( CMBS ) sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for 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 estimated fair value of our securities would generally decrease based upon an increase in serious delinquencies. Conversely, the estimated fair value of our securities would generally increase if the prepayment rate or credit support inputs were to increase.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

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

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at September 30, 2013, we received dealer price indications on 78% of our securities, representing 91% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were 1% 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 September 30, 2013 and December 31, 2012, we had no Level 3 derivatives.

*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 estimated fair value of the MSRs and alternatively, a decrease in these inputs will increase the estimated fair value of the MSRs. As part of our MSR valuation process, we received a valuation estimate from a third-party valuations group. In the aggregate, our internal valuation of the MSRs was less than 1% lower than the third-party valuation.



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**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
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**September 30, 2013**

**(Unaudited)**

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

*REO*

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

*Margin receivable*

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

*Short-term debt*

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

*ABS issued*

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

As part of our ABS issued valuation process, we also request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at September 30, 2013, we received dealer price indications on 41% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were 2% 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.

*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).

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

**September 30, 2013**

**(Unaudited)**

**Note 6. Residential Loans**

We acquire residential loans from third-party originators. During the nine months ended September 30, 2013, we purchased \$6.35 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 September 30, 2013 and December 31, 2012.

**September 30, 2013**

(In Thousands)	Redwood	Sequoia	Total
Held-for-sale			
Fair value	\$ 726,161	\$ -	\$ 726,161
Lower of cost or fair value	1,718	-	1,718
Held-for-investment	-	1,864,653	1,864,653
<b>Total Residential Loans</b>	<b>\$ 727,879</b>	<b>\$ 1,864,653</b>	<b>\$ 2,592,532</b>

**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
<b>Total Residential Loans</b>	<b>\$ 562,658</b>	<b>\$ 2,272,812</b>	<b>\$ 2,835,470</b>

***Residential Loans Held-for-Sale***

*Residential Loans at Fair Value*

At September 30, 2013, there were 933 residential loans at fair value, with an aggregate outstanding principal balance of \$722 million and an aggregate fair value of \$726 million. During the three and nine months ended September 30, 2013, we recorded \$11 million and \$17 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 September 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 nine months ended September 30, 2013, we recorded valuation adjustments for residential loans held-for-sale of negative \$11 thousand and positive \$68 thousand, respectively. During the three and nine months ended September 30, 2012, we recorded valuation adjustments for residential loans held-for-sale of negative \$367 thousand and positive \$131 thousand, respectively.

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

**September 30, 2013**

**(Unaudited)**

**Note 6. Residential Loans (continued)***Residential Loans Held-for-Investment*

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

<b>(In Thousands)</b>	<b>September 30, 2013</b>		<b>December 31, 2012</b>	
Principal balance	\$	1,869,726	\$	2,278,069
Unamortized premium, net		18,142		23,247
Recorded investment		1,887,868		2,301,316
Allowance for loan losses		(23,215)		(28,504)
<b>Carrying Value</b>	<b>\$</b>	<b>1,864,653</b>	<b>\$</b>	<b>2,272,812</b>

Of the \$1.87 billion of principal balance and \$18 million of unamortized premium on loans held-for-investment at September 30, 2013, \$776 million of principal balance and \$12 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the nine months ended September 30, 2013, 15% of these residential loans prepaid and we amortized 26% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal balance was \$1.10 billion and the unamortized premium was \$7 million. During the nine months ended September 30, 2013, 20% of these loans prepaid and we amortized 14% 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 September 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. The weighted average original LTV ratio for our residential loans held-for-investment outstanding at September 30, 2013, was 66%. The weighted average FICO score for the borrowers of these loans was 733 at the time the loans were originated.

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

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
2003 & Earlier	\$ 942,405	\$ 1,131,200
2004	528,728	569,379
2005	66,821	71,792
2006	151,067	164,333
2007	-	-
2008	-	-
2009	30,395	58,628
2010	102,385	197,964
2011	66,067	108,020
<b>Total Recorded Investment</b>	<b>\$ 1,887,868</b>	<b>\$ 2,301,316</b>

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

**September 30, 2013**

**(Unaudited)**

**Note 6. Residential Loans (continued)***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 nine months ended September 30, 2013 and 2012.

<b>(In Thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Balance at beginning of period	\$ 23,150	\$ 55,449	\$ 28,504	\$ 66,881
Charge-offs, net	(818)	(2,514)	(3,363)	(7,653)
Provision for (reversal of) provision for loan losses	883	813	(1,926)	(902)
Deconsolidation adjustment	-	-	-	(4,578)
<b>Balance at End of Period</b>	<b>\$ 23,215</b>	<b>\$ 53,748</b>	<b>\$ 23,215</b>	<b>\$ 53,748</b>

During the three months ended September 30, 2013 and 2012, there were less than \$1 million and \$3 million of charge-offs of residential loans that reduced our allowance for loan losses, respectively. These charge-offs arose from \$3 million and \$7 million of defaulted loan principal, respectively. During the nine months ended September 30, 2013 and 2012, there were \$3 million and \$8 million of charge-offs of residential loans, respectively, that reduced our allowance for loan losses. These charge-offs arose from \$10 million and \$21 million of defaulted loan principal, respectively.

*Residential Loans Collectively Evaluated for Impairment*

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

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

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Principal balance	\$ 1,861,027	\$ 2,272,104
Recorded investment	1,879,355	2,295,471
Related allowance	22,332	27,891

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

<b>(In Thousands)</b>	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>90+ Days Past Due</b>	<b>Current</b>	<b>Total Loans</b>
September 30, 2013	\$ 37,850	\$ 15,778	\$ 69,236	\$ 1,756,491	\$ 1,879,355
December 31, 2012	29,345	17,593	62,937	2,185,596	2,295,471



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## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

**Note 6. Residential Loans (continued)***Residential Loans Individually Evaluated for Impairment*

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for qualifying borrowers and potentially reduce a future impairment. For the nine months ended September 30, 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 nine months ended September 30, 2013 and 2012.

(Dollars in Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>TDRs</b>				
Number of modifications	5	4	12	10
Pre-modification outstanding recorded investment	\$ 1,144	\$ 1,337	\$ 2,939	\$ 3,848
Post-modification outstanding recorded investment	898	1,397	2,838	3,823
Loan modification effect on net interest income after provision and other MVA	(555)	(410)	(863)	(1,007)

**TDRs that Subsequently Defaulted**

Number of modifications	1	2	4	6
Recorded investment	\$ 201	\$ 1,301	\$ 788	\$ 2,987

If we determine that a restructured loan is a TDR, we remove it from the general loan pools used for determining the allowance for residential loan losses and assess it for impairment on an individual basis. This assessment is based primarily on whether an adverse change in the expected future cash flows resulted from the restructuring. The average recorded investment of loans individually evaluated for impairment for the three months ended September 30, 2013

and 2012, was \$8 million and \$16 million, respectively. For the three months ended September 30, 2013 and 2012, we recorded interest income of \$81 thousand and \$22 thousand, respectively, on individually impaired loans. The average recorded investment of loans individually evaluated for impairment for the nine months ended September 30, 2013 and 2012, was \$7 million and \$15 million, respectively. For the nine months ended September 30, 2013 and 2012, we recorded interest income of \$102 thousand and \$281 thousand, respectively, on individually impaired loans.

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

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Principal balance	\$ 8,699	\$ 5,965
Recorded investment	8,513	5,845
Related allowance	883	613

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

<b>(In Thousands)</b>	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>90+ Days Past Due</b>	<b>Current</b>	<b>Total Loans</b>
September 30, 2013	\$ 1,399	\$ 381	\$ 193	\$ 6,540	\$ 8,513
December 31, 2012	160	645	-	5,040	5,845

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 7. Commercial Loans**

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

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Held-for-sale		
Fair value	\$ 27,413	\$ -
Lower of cost or fair value	-	8,500
Held-for-investment	352,440	304,510
<b>Total Commercial Loans</b>	<b>\$ 379,853</b>	<b>\$ 313,010</b>

***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 September 30, 2013, there were 4 senior commercial loans at fair value, with an aggregate outstanding principal balance of \$27 million and an aggregate fair value of \$27 million. During the three and nine months ended September 30, 2013, we recorded \$3 million of positive 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.

***Commercial Loans at Lower of Cost or Fair Value***

At September 30, 2013, there were no commercial loans held at the lower of cost or fair value. During both the nine months ended September 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 nine months ended September 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 September 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 September 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Principal balance	\$ 361,759	\$ 312,400
Unamortized discount, net	(2,815)	(3,806)
Recorded investment	358,944	308,594
Allowance for loan losses	(6,504)	(4,084)
<b>Carrying Value</b>	<b>\$ 352,440</b>	<b>\$ 304,510</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 7. Commercial Loans (continued)**

At September 30, 2013, there were 50 commercial loans held-for-investment with an outstanding principal balance of \$362 million and a carrying value of \$352 million. Of the \$359 million of recorded investment in commercial loans held-for-investment at September 30, 2013, 17% was originated in 2013, 44% 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 nine months ended September 30, 2013 and 2012.

<b>(In Thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Balance at beginning of period	\$ 5,660	\$ 1,258	\$ 4,084	\$ 608
Charge-offs, net	-	-	-	-
Provision for loan losses	844	506	2,420	1,156
<b>Balance at End of Period</b>	<b>\$ 6,504</b>	<b>\$ 1,764</b>	<b>\$ 6,504</b>	<b>\$ 1,764</b>

***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 September 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 September 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Principal balance	\$ 361,759	\$ 312,400
Recorded investment	358,944	308,594
Related allowance	6,504	4,084

***Commercial Loans Individually Evaluated for Impairment***

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

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Residential	\$ 1,324,678	\$ 1,094,684
Commercial	-	14,069
<b>Total Real Estate Securities</b>	<b>\$ 1,324,678</b>	<b>\$ 1,108,753</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 8. Real Estate Securities (continued)**

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.

***Trading Securities***

We elected the fair value option for certain securities and classify them as trading securities. At September 30, 2013, our trading securities included \$127 million of interest-only securities, for which there is no principal balance, and \$4 million of residential subordinate securities. The unpaid principal balance of residential subordinate securities classified as trading was \$15 million and \$12 million at September 30, 2013 and December 31, 2012, respectively. The following table presents trading securities by collateral type at September 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
<b>Senior Securities</b>		
Residential prime	\$ 117,443	\$ 10,409
Residential non-prime	8,864	22,134
<b>Total Senior Securities</b>	<b>126,307</b>	<b>32,543</b>
<b>Subordinate Securities</b>		
Residential prime	4,547	468
Residential non-prime	-	161
<b>Total Subordinate Securities</b>	<b>4,547</b>	<b>629</b>
<b>Total Trading Securities</b>	<b>\$ 130,854</b>	<b>\$ 33,172</b>

***AFS Securities***

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

(In Thousands)	September 30, 2013	December 31, 2012
<b>Senior Securities</b>		
Residential prime	\$ 363,822	\$ 466,523
Residential non-prime	195,154	245,266
<b>Total Senior Securities</b>	558,976	711,789
<b>Re-REMIC Securities</b>	156,346	163,035
<b>Subordinate Securities</b>		
Residential prime	478,369	184,528
Residential non-prime	133	2,160
Commercial	-	14,069
<b>Total Subordinate Securities</b>	478,502	200,757
<b>Total AFS Securities</b>	\$ 1,193,824	\$ 1,075,581



Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 8. Real Estate Securities (continued)**

The senior securities shown above at September 30, 2013 and December 31, 2012, included \$141 million and \$172 million, respectively, of prime securities, and \$135 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.

At September 30, 2013, there were \$1 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 September 30, 2013 and December 31, 2012.

***Carrying Value of Residential AFS Securities***

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Principal balance	\$ 1,481,198	\$ 1,277,401
Credit reserve	(136,292)	(187,032)
Unamortized discount, net	(288,838)	(203,421)
Amortized cost	1,056,068	886,948
Gross unrealized gains	155,972	176,929
Gross unrealized losses	(18,216)	(2,365)
<b>Carrying Value</b>	<b>\$ 1,193,824</b>	<b>\$ 1,061,512</b>

The following table presents the changes for the three and nine months ended September 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*

<b>(In Thousands)</b>	<b>Three Months Ended September 30, 2013</b>	
	<b>Credit Reserve</b>	<b>Unamortized Discount, Net</b>
Beginning balance	\$ 190,410	\$ 235,846
Amortization of net discount	-	(8,785)
Realized credit losses	(4,940)	-
Acquisitions	3,669	30,361
Sales, calls, other	(17,597)	(3,834)
Impairments	-	-
Transfers to (release of) credit reserves, net	(35,250)	35,250
<b>Ending Balance</b>	<b>\$ 136,292</b>	<b>\$ 288,838</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 8. Real Estate Securities (continued)**

<b>(In Thousands)</b>	<b>Nine Months Ended September 30, 2013</b>	
	<b>Credit Reserve</b>	<b>Unamortized Discount, Net</b>
Beginning balance	\$ 187,032	\$ 203,421
Amortization of net discount	-	(24,632)
Realized credit losses	(16,905)	-
Acquisitions	12,066	84,884
Sales, calls, other	(17,935)	(4,467)
Impairments	1,666	-
Transfers to (release of) credit reserves, net	(29,632)	29,632
<b>Ending Balance</b>	<b>\$ 136,292</b>	<b>\$ 288,838</b>

***Credit Characteristics of Residential AFS Securities***

Of the \$136 million of credit reserve on our residential securities at September 30, 2013, \$26 million was related to residential senior securities, \$33 million was related to residential re-REMIC securities, and \$77 million was related to residential subordinate securities. The loans underlying our \$364 million of prime residential senior securities totaled \$9 billion at September 30, 2013, and the loans underlying our \$195 million of non-prime residential senior securities totaled \$4 billion. Serious delinquencies on loans underlying our senior securities at September 30, 2013, were 9.51% of outstanding principal balances. The loans underlying our residential re-REMIC securities totaled \$4 billion at September 30, 2013, and consisted of \$4 billion prime and \$101 million non-prime credit quality collateral at time of origination. Serious delinquencies on loans underlying our re-REMIC securities at September 30, 2013, were 9.50% of outstanding principal balances. The loans underlying our residential subordinate securities totaled \$17 billion at September 30, 2013, and consisted of \$16 billion prime and \$300 million non-prime credit quality at time of origination. Serious delinquencies on loans underlying our subordinate securities at September 30, 2013, were 3.29% 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 September 30, 2013 and December 31, 2012.

(In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
September 30, 2013	\$ 431,721	\$ (16,998)	\$ 414,723	\$ 11,020	\$ (1,218)	\$ 9,802
December 31, 2012	22,803	(293)	22,510	26,729	(2,072)	24,657

At September 30, 2013, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 297 AFS securities, of which 63 were in an unrealized loss position and seven 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 September 30, 2013.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 8. Real Estate Securities (continued)***Significant Valuation Assumptions*

<b>September 30, 2013</b>	<b>Range for Securities</b>	
	<b>Prime</b>	<b>Non-prime</b>
Prepayment rates	4 - 50 %	3 - 10 %
Loss severity	15 -56 %	30 -59 %
Projected losses	0 - 38 %	4 - 15 %

For an AFS security with a fair value that 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 September 30, 2013 and 2012. The balance of the credit component of OTTI at September 30, 2013 and 2012 includes all market valuation adjustments recorded through the income statement for securities still held on our balance sheet at September 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*

<b>(In Thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Balance at beginning of period	\$ 42,674	\$ 67,054	\$ 50,852	\$ 78,126
Additions				
Initial credit impairments	-	164	-	325
Subsequent credit impairments	-	58	-	149
Reductions				
Securities sold, or expected to sell	(3,288)	(9,069)	(5,479)	(9,069)
Securities with no outstanding principal at period end	(764)	(4,310)	(6,751)	(15,634)

<b>Balance at End of Period</b>	\$	38,622	\$	53,897	\$	38,622	\$	53,897
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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 and losses on sales and calls of AFS securities for the three and nine months ended September 30, 2013 and 2012.

<b>(In Thousands)</b>	<b>Three Months Ended</b>		<b>Nine Months Ended September 30,</b>	
	<b>September 30,</b>		<b>2013</b>	<b>2012</b>
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Gross realized gains - sales	\$ 10,532	\$ 13,920	\$ 22,762	\$ 28,693
Gross realized gains - calls			333	113
Gross realized losses - sales	(214)		(214)	(1,600)
Gross realized losses - calls				
<b>Total Realized Gains on Sales and Calls of AFS Securities, net</b>	<b>\$ 10,318</b>	<b>\$ 13,920</b>	<b>\$ 22,881</b>	<b>\$ 27,206</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 9. Derivative Financial Instruments**

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

(In Thousands)	September 30, 2013		December 31, 2012	
	Fair Value	Notional Amount	Fair Value	Notional Amount
<b>Assets - Risk Management</b>				
<b>Derivatives</b>				
Interest rate swaps	\$ 3,539	\$ 122,000	\$ 739	\$ 147,000
TBAs	745	69,000		
Futures				
Swaptions	568	385,000	2,233	575,000
<b>Total Assets</b>	\$ 4,852	\$ 576,000	\$ 2,972	\$ 722,000
<b>Liabilities - Cash Flow</b>				
<b>Hedges</b>				
Interest rate swaps	\$ (23,550)	\$ 139,500	\$ (48,581)	\$ 139,500
<b>Liabilities - Risk Management Derivatives</b>				
Interest rate swaps	(2,806)	162,500	(1,893)	357,500
TBAs	(5,810)	341,000		
Futures	(531)	180,000	(607)	234,000
<b>Total Liabilities</b>	\$ (32,697)	\$ 823,000	\$ (51,081)	\$ 731,000
<b>Total Derivative Financial Instruments, Net</b>	\$ (27,845)	\$ 1,399,000	\$ (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 September 30, 2013, we were party to interest rate agreements with an aggregate notional amount of \$669 million, TBA contracts sold with an aggregate notional amount of \$410 million and financial futures contracts with an aggregate notional amount of \$180 million. Net market valuation adjustments on risk management derivatives related to unsecuritized loans we own or plan to acquire were positive less than \$1 million for the three months ended September 30, 2013 and 2012. Net market valuation adjustments on risk management derivatives related to unsecuritized loans we own or plan to acquire were \$51 million and negative \$9 million for the nine months ended September 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 September 30, 2013 and 2012, these cash flow hedges increased in value by \$4 million and \$2 million, respectively, which was recorded as an increase to accumulated other comprehensive income, a component of equity. For the nine months ended September 30, 2013 and 2012, these cash flow hedges increased in value by \$25 million and \$2 million,



Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 9. Derivative Financial Instruments (continued)**

respectively. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was \$23 million and \$48 million at September 30, 2013 and December 31, 2012, respectively. For the three months ended September 30, 2013 and 2012, we reclassified less than \$1 million of unrealized losses on derivatives to interest expense. For the nine months ended September 30, 2013 and 2012, we reclassified less than \$1 million and \$3 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 nine months ended September 30, 2013 and 2012.

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

<b>(In Thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net interest expense on cash flow interest rate agreements	\$ (1,474)	\$ (1,409)	\$ (4,406)	\$ (4,361)
Realized expense due to ineffective portion of hedges	-	-	-	(34)
Realized net losses reclassified from other comprehensive income	(62)	(1,126)	(219)	(3,260)
<b>Total Interest Expense</b>	<b>\$ (1,536)</b>	<b>\$ (2,535)</b>	<b>\$ (4,625)</b>	<b>\$ (7,655)</b>

***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 September 30, 2013, we assessed this risk as remote and did not record a specific valuation adjustment.

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

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 10. Other Assets**

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

*Other Assets*

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Margin receivable	\$ 46,970	\$ 63,424
Investment receivable	1,821	153
Other pledged collateral	5,000	
REO	4,050	4,245
Prepaid expenses	2,206	1,684
Fixed assets and leasehold improvements	1,065	494
Income tax receivables	895	4,762
Other	1,080	618
<b>Total Other Assets</b>	<b>\$ 63,087</b>	<b>\$ 75,380</b>

REO consists of foreclosed properties received in satisfaction of defaulted real estate loans. The carrying value of REO at September 30, 2013, was \$4 million, which includes the net effect of \$3 million related to transfers into REO during the first nine months of 2013, offset by \$3 million of REO liquidations, and less than \$1 million of negative market valuation adjustments. At September 30, 2013 and December 31, 2012, there were 22 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, and Alabama accounted for 64% of our REO properties at September 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 September 30, 2013, we had outstanding agreements with 13 counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 *Management's Discussion and Analysis of Financial Condition and Results of Operations* of this Quarterly Report on Form 10-Q. The table below

summarizes the facilities that are available to us and the balances of short-term debt at September 30, 2013 and December 31, 2012 by the type of collateral securing the debt.

(Dollars in Thousands)	Number of Facilities	September 30, 2013		Maturity
		Outstanding	Limit	
<b>Collateral Type</b>				
Residential loans	5	\$ 461,584	\$ 1,650,000	11/2013-8/2014
Commercial loans	1	5,514	100,000	4/2014
Real estate securities	7	371,201	-	10/2013-11/2013
<b>Total</b>	13	\$ 838,299		

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## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

## Note 11. Short-Term Debt (continued)

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

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At September 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 \$519 million and \$500 million, respectively, at September 30, 2013. For the three and nine months ended September 30, 2013, the average balance of short-term debt was \$1.15 billion and \$1.02 billion, respectively. For the three and nine months ended September 30, 2012, the average balance of short-term debt was \$571 million and \$469 million, respectively. At both September 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 September 30, 2013 and December 31, 2012.

(Dollars in Thousands)	September 30, 2013			December 31, 2012		
	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
<b>Collateral Type</b>						
Residential loan collateral	\$ 461,584	1.74%	157	\$ 179,982	1.76%	212
Commercial loan collateral	5,514	2.44%	208	-	-	-
Real estate securities collateral	371,201	1.59%	27	371,936	1.83%	23

<b>Total Short-Term Debt</b>	\$ 838,299	1.68%	100	\$ 551,918	1.81%	84
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***Remaining Maturities of Short-Term Debt***

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

<b>(In Thousands)</b>	<b>September 30, 2013</b>		<b>December 31, 2012</b>	
Within 30 days	\$	345,333	\$	362,279
31 to 90 days		206,281		48,848
Over 90 days		286,685		140,791
<b>Total Short-Term Debt</b>	\$	838,299	\$	551,918

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****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.

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

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

***Asset-Backed Securities Issued***

(Dollars in Thousands)	September 30, 2013			
	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Certificates with principal balance	\$ 1,804,951	\$ 112,179	\$ 158,799	\$ 2,075,929
Interest-only certificates	4,014	-	-	4,014
Unamortized premium	-	-	-	-
Unamortized discount	(18,278)	-	-	(18,278)
<b>Total ABS Issued</b>	<b>\$ 1,790,687</b>	<b>\$ 112,179</b>	<b>\$ 158,799</b>	<b>\$ 2,061,665</b>
Range of weighted average interest rates, by series	0.33% to 4.22%	2.21%	5.62%	
Stated maturities	2014 - 2047	2046	2018	

Number of series	24	1	1
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(Dollars in Thousands)	December 31, 2012			Total
	Sequoia	Residential Resecuritization	Commercial Securitization	
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)
<b>Total ABS Issued</b>	<b>\$ 2,193,481</b>	<b>\$ 164,746</b>	<b>\$ 171,714</b>	<b>\$ 2,529,941</b>
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	



Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 12. Asset-Backed Securities Issued (continued)**

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 September 30, 2013, \$2.03 billion of ABS issued (\$2.04 billion principal balance) had contractual maturities of over five years and \$32 million of ABS issued (\$32 million principal balance) had contractual maturities of one to five years. Amortization of deferred ABS issuance costs was \$3 million and \$2 million for the nine months ended September 30, 2013 and 2012, respectively.

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

***Accrued Interest Payable on Asset-Backed Securities Issued***

<b>(In Thousands)</b>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Sequoia	\$ 1,322	\$ 2,103
Residential Resecuritization	27	40
Commercial Securitization	744	832
<b>Total Accrued Interest Payable on ABS Issued</b>	<b>\$ 2,093</b>	<b>\$ 2,975</b>

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

***Collateral for Asset-Backed Securities Issued***

<b>(In Thousands)</b>	<b>September 30, 2013</b>			<b>Total</b>
	<b>Sequoia</b>	<b>Residential Resecuritization</b>	<b>Commercial Securitization</b>	
Residential loans	\$ 1,864,653	\$ -	\$ -	\$ 1,864,653
Commercial loans	-	-	269,255	269,255

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Real estate securities	-	275,763	-	275,763
Restricted cash	159	-	138	297
Accrued interest receivable	3,061	682	1,933	5,676
REO	4,050	-	-	4,050
<b>Total Collateral for ABS Issued</b>	<b>\$ 1,871,923</b>	<b>\$ 276,445</b>	<b>\$ 271,326</b>	<b>\$ 2,419,694</b>

(In Thousands)	December 31, 2012			
	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
<b>Total Collateral for ABS Issued</b>	<b>\$ 2,281,688</b>	<b>\$ 325,445</b>	<b>\$ 285,879</b>	<b>\$ 2,893,012</b>

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

**September 30, 2013**

**(Unaudited)**

**Note 13. Long-Term Debt**

*Commercial Borrowings*

At September 30, 2013, we had one commercial loan repurchase facility with an outstanding balance of \$45 million and a total borrowing limit of \$150 million, with a remaining maturity of 24 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 nine months ended September 30, 2013, the average balance of this commercial borrowing was \$33 million and \$18 million, respectively. The fair value of commercial loans pledged as collateral was \$72 million at September 30, 2013. The interest expense yield on this borrowing was 7.93% and 6.95% respectively, for the three and nine months ended September 30, 2013. There was no balance on this warehouse facility at December 31, 2012.

At September 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 \$287.5 million principal amount of 4.625% convertible senior notes due 2018. These convertible notes require semi-annual interest distributions at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. 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 5.49%, respectively, for the three and nine months ended September 30, 2013. At September 30, 2013, the accrued interest payable balance on this debt was \$8 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 September 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 2.83% for the nine months ended September 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 6.90% and 6.87% for the nine months ended September 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 2.83% for the nine months ended September 30, 2013 and 2012, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our subordinated notes was 6.90% and 6.87% for the nine months ended September 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.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
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**September 30, 2013**

**(Unaudited)**

**Note 13. Long-Term Debt (continued)**

At both September 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 September 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 \$2 million. During the second quarter of 2013, we also entered into an amendment to this lease to expand the original premises. We do not have a 2013 rent obligation for this amended lease due to an abatement period through the first quarter of 2014. The total rent obligation through 2021 is \$2 million. Operating lease expense was less than \$1 million for both the nine months ended September 30, 2013 and 2012.

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

*Future Lease Commitments by Year*

<b>(In Thousands)</b>	<b>September 30, 2013</b>
2013 (three months)	\$ 444
2014	2,250
2015	2,302
2016	2,056
2017	2,111
2018 and thereafter	2,384

<b>Total</b>	<b>\$</b>	<b>11,547</b>
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Leasehold improvements for our offices are amortized into expense over the lease term. There were \$200 thousand of unamortized leasehold improvements at September 30, 2013. For the nine months ended September 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.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

**Note 14. Commitments and Contingencies (continued)**

(net of interest received) as well as attorneys' fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, as of September 30, 2013, the FHLB-Seattle has received approximately \$113.3 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 September 30, 2013, Schwab has received approximately \$12.6 million of principal and \$1.3 million of interest payments in respect of the Schwab Certificate. SRF has denied Schwab's allegations. This case is in 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, as of September 30, 2013, the FHLB Chicago has received approximately \$71.5 million of principal and \$24.0 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, as of September 30, 2013, the FHLB Chicago has received approximately \$256.1 million of principal and \$80.7 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.



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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2013**

**(Unaudited)**

**Note 14. Commitments and Contingencies (continued)**

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. We have not established reserves in connection with these litigation matters, as we have not concluded that a material loss is both probable and estimable at the current stages of these matters. There are numerous factors that have contributed to this conclusion, 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 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 certain of the above-referenced matters, we have engaged and may continue to engage in formal or informal settlement communications with the plaintiffs. While we have not engaged in any settlement communications in the above-referenced litigation matters that have caused us to determine that a material loss from these matters is probable, settlement discussions we have had relating to certain of the above-referenced matters during the third quarter of 2013 are a factor that has contributed to our concluding that we can estimate a range of reasonably possible losses with respect to the above-referenced litigation matters. Accordingly, based on developments during the course of these litigations, we estimate that the aggregate range of reasonably possible losses on the above-referenced litigation matters is between zero and \$25 million. However, future developments (including resolution of substantive pre-trial motions relating to these matters, receipt of additional information and documents relating to these matters (such as through pre-trial discovery), new or additional settlement communications with plaintiffs relating to these matters, or resolutions of similar claims against other defendants in these matters) could result in our concluding in the future to establish loss contingency reserves or modify our aggregate range of reasonably possible losses with respect to these matters. Our actual losses and any loss contingency reserves we may establish in the future may be materially higher than the aggregate range of reasonably possible losses we have estimated above, including in the event that any of these matters proceed to trial and the plaintiffs prevail. We cannot be certain that any of these matters will be resolved through a settlement prior to trial and we cannot be certain that the resolution of these matters, whether

through trial or settlement, will not have a material adverse effect on our financial condition or results of operations in any future period.

### Note 15. Equity

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

#### *Changes in Accumulated Other Comprehensive Income by Component*

<b>Three Months Ended September 30, 2013</b>	<b>Net unrealized gains on available-for-sale securities</b>	<b>Net unrealized losses on interest rate agreements accounted for as cash flow hedges</b>
<b>(In Thousands)</b>		
Balance at beginning of period	\$ 145,349	\$ (27,066)
Other comprehensive (loss) income before reclassifications	(633)	4,018
Amounts reclassified from other accumulated comprehensive income	(6,962)	62
Net current-period other comprehensive (loss) income	(7,595)	4,080
<b>Balance at End of Period</b>	<b>\$ 137,754</b>	<b>\$ (22,986)</b>

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

**September 30, 2013**

**(Unaudited)**

**Note 15. Equity (continued)**

<b>Nine Months Ended September 30, 2013</b>	<b>Net unrealized gains on available-for-sale securities</b>	<b>Net unrealized losses on interest rate agreements accounted for as cash flow hedges</b>
<b>(In Thousands)</b>		
Balance at beginning of period	\$ 186,580	\$ (48,248)
Other comprehensive (loss) income before reclassifications	(29,615)	25,043
Amounts reclassified from other accumulated comprehensive income	(19,211)	219
Net current-period other comprehensive (loss) income	(48,826)	25,262
<b>Balance at End of Period</b>	<b>\$ 137,754</b>	<b>\$ (22,986)</b>

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

***Reclassifications out of Accumulated Other Comprehensive Income***

<b>(In Thousands)</b>	<b>Affected line item in the statement where net income is presented</b>	<b>Amount reclassified from accumulated other comprehensive income</b>	
		<b>Three Months Ended September 30, 2013</b>	<b>Nine Months Ended September 30, 2013</b>
<b>Net realized gains (losses) on AFS securities</b>			
Other than temporary impairment	Other market valuations, net	\$ -	\$ (124)
Gain on sale of AFS securities	Realized gains, net	(6,962)	(19,087)
		\$ (6,962)	\$ (19,211)

<b>Net realized gains on interest rate agreements designated as cash flow hedges</b>					
Amortization of deferred loss	Interest expense	\$	62	\$	219
		\$	62	\$	219

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## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 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 nine months ended September 30, 2013 and 2012.

*Basic and Diluted Earnings Per Common Share*

(In Thousands, Except Share Data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>Basic Earnings Per Common Share:</b>				
Net income attributable to Redwood	\$ 21,929	\$ 39,701	\$ 148,112	\$ 89,691
Less: Dividends and undistributed earnings allocated to participating securities	(565)	(1,104)	(4,209)	(2,631)
Net income allocated to common shareholders	\$ 21,364	\$ 38,597	\$ 143,903	\$ 87,060
Basic weighted average common shares outstanding	82,201,473	79,685,099	81,888,231	78,908,057
<b>Basic Earnings Per Common Share</b>	<b>\$ 0.26</b>	<b>\$ 0.48</b>	<b>\$ 1.76</b>	<b>\$ 1.10</b>
<b>Diluted Earnings Per Common Share:</b>				
Net income attributable to Redwood	\$ 21,929	\$ 39,701	\$ 148,112	\$ 89,691
Less: Dividends and undistributed earnings allocated to participating securities	(565)	(861)	(3,030)	(2,200)
Add back: Interest expense on convertible notes	-	-	8,790	-
	<b>\$ 21,364</b>	<b>\$ 38,840</b>	<b>\$ 153,872</b>	<b>\$ 87,491</b>

Net income allocated to common shareholders				
Weighted average common shares outstanding	82,201,473	79,685,099	81,888,231	78,908,057
Net effect of dilutive equity awards	2,220,566	1,079,281	2,292,451	1,267,603
Net effect of assumed convertible notes conversion to common shares	-	-	9,053,183	-
Diluted weighted average common shares outstanding	84,422,039	80,764,380	93,233,865	80,175,660

**Diluted Earnings Per Common Share**

\$ 0.25      \$ 0.48      \$ 1.65      \$ 1.09

For the three and nine months ended September 30, 2013, there were 2,220,566 and 2,292,451 of dilutive equity awards, respectively, determined under the two-class method. For the three and nine months ended September 30, 2012, there were 1,079,281 and 1,267,603 dilutive equity awards determined under the two-class method. We included participating securities in the calculation of diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances. For the nine months ended September 30, 2013, 9,053,183 common shares related to the assumed conversion of the convertible notes were included in the calculation of diluted earnings per share.

For the three months ended September 30, 2013, 11,825,450 common shares related to the assumed conversion of the convertible notes were antidilutive and were excluded in the calculation of diluted earnings per share. For the three months ended September 30, 2013 and 2012, the number of outstanding equity awards that were antidilutive totaled 190,627 and 1,014,274, respectively, under the two-class method. For the nine months ended September 30, 2013 and 2012, the number of outstanding equity awards that were antidilutive totaled 244,174 and 704,087, respectively, under the two-class method. There were no other participating securities during these periods.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 15. Equity (continued)*****Stock Repurchases***

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the nine months ended September 30, 2013, there were no shares acquired under the plan. At September 30, 2013, there remained 4,005,985 shares available for repurchase under this plan.

**Note 16. Equity Compensation Plans**

At September 30, 2013 and December 31, 2012, 2,022,530 and 666,610 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled \$13 million at September 30, 2013, as shown in the following table.

<b>(In Thousands)</b>	<b>Nine Months Ended September 30, 2013</b>					
	<b>Stock Options</b>	<b>Restricted Stock</b>	<b>Deferred Stock Units</b>	<b>Stock Units</b>	<b>Employee Stock Purchase Plan</b>	<b>Total</b>
Unrecognized compensation cost at beginning of period	\$ -	\$ 1,822	\$ 13,378	\$ 6,484	\$ -	\$ 21,684
Equity grants	-	175	1,030	-	217	1,422
Equity grant forfeitures	-	(350)	(1,221)	(876)	-	(2,447)
Equity compensation expense	-	(468)	(4,985)	(2,264)	(163)	(7,880)
<b>Unrecognized Compensation Cost at End of Period</b>	<b>\$ -</b>	<b>\$ 1,179</b>	<b>\$ 8,202</b>	<b>\$ 3,344</b>	<b>\$ 54</b>	<b>\$ 12,779</b>

At September 30, 2013, the weighted average amortization period remaining for all of our equity awards was less than two years.

***Stock Options***

At September 30, 2013 and December 31, 2012, there were 190,543 and 287,516 fully vested stock options outstanding, respectively. There was no aggregate intrinsic value for the options outstanding and exercisable at September 30, 2013. For both the nine months ended September 30, 2013 and 2012, there were no stock options exercised. For the nine months ended September 30, 2013, 96,973 stock options expired.

***Restricted Stock***

At September 30, 2013 and December 31, 2012, there were 123,156 and 190,088 shares, respectively, of restricted stock awards outstanding. Restrictions on these shares lapse through 2017. There were 5,936 and 7,032 restricted stock awards granted during the three and nine months ended September 30, 2013, respectively.

***Deferred Stock Units***

At September 30, 2013 and December 31, 2012, there were 1,976,215 and 2,361,285 DSUs outstanding, respectively, of which 1,159,249 and 1,119,753, respectively, had vested. There were zero and 232,794 DSUs granted during the three and nine months ended September 30, 2013, respectively. During the three and nine months ended September 30, 2013, there were 40,316 and 70,700 DSUs forfeited related to employee departures, respectively. During the nine months ended September 30, 2013, there were 547,164 DSU distributions and cash distributions of less than \$1 million to participants in the EDCP. Unvested DSUs at September 30, 2013 vest through 2017.



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

**September 30, 2013**

**(Unaudited)**

**Note 16. Equity Compensation Plans (continued)***Performance Stock Units*

At September 30, 2013 and December 31, 2012, there were 762,375 and 837,737 PSUs outstanding, respectively, none of which had vested. During the three and nine months ended September 30, 2013, there were zero and 75,362 PSUs forfeited related to employee departures, respectively. PSUs cliff vest on the third anniversary of their grant date, with vesting contingent on total stockholder return (defined as the change in our common stock price plus dividends paid on our common stock relative to the per share price of our common stock on the date of the PSU grant) over the three-year vesting period ( Three-Year TSR ). The number of underlying shares of our common stock that will vest during 2013 and in future years will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period.

*Employee Stock Purchase Plan*

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. At September 30, 2013 and December 31, 2012, 234,977 and 207,031 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

**Note 17. Mortgage Banking Activities**

The following table presents the components of mortgage banking activities, net, recorded in our consolidated income statements for the three and nine months ended September 30, 2013 and 2012.

*Components of Mortgage Banking Activities, Net*

<b>(In Thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Income from MSR's, net:				
Income	\$ 2,991	\$ 231	\$ 5,785	\$ 368
Late charges	17	2	35	3
Cost of sub-servicer	(355)	(55)	(767)	(89)

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Income from MSR, net:	2,653	178	5,053	282
Changes in fair value of:				
Residential loans, at fair value	(10,804)	14,976	(17,339)	14,992
Commercial loans, at fair value	3,171	-	2,826	-
MSRs	460	(650)	9,628	(1,194)
Sequoia IO securities	(1,866)	(4,427)	36,399	(9,101)
Risk management derivatives <sup>(1)</sup>	442	(2,385)	51,010	(8,784)
Net market valuation adjustments	(8,597)	7,514	82,524	(4,087)
Net gains on residential loan sales	-	4,611	-	17,447
Net gains on commercial loan originations	-	-	40	-
Net gains on commercial loan sales	-	-	10,991	-
<b>Mortgage Banking Activities, Net</b>	<b>\$ (5,944)</b>	<b>\$ 12,303</b>	<b>\$ 98,608</b>	<b>\$ 13,642</b>

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

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2013****(Unaudited)****Note 17. Mortgage Banking Activities (continued)*****Mortgage Servicing Rights***

During the three and nine months ended September 30, 2013, we transferred an aggregate \$1.21 billion and \$5.25 billion (principal balance), respectively, of residential loans to 11 Sequoia securitization entities and accounted for the transfers as sales in accordance with GAAP. As a result of these sales, during the three and nine months ended September 30, 2013, we recorded MSR of \$13 million and \$41 million, respectively, at a taxable REIT subsidiary of ours. These MSRs represent rights we had acquired and retained to service \$1.19 billion and \$4.53 billion of loans transferred (original principal balance) to these securitizations during the three and nine months ended September 30, 2013, respectively. During the three and nine months ended September 30, 2013, we recorded MSR of \$1 million associated with \$72 million of loans sold to third parties. During the three and nine months ended September 30, 2013, we purchased \$3 million of MSR associated with \$307 million of conforming loan principal balance. Conforming loans are mortgage loans that conform to Fannie Mae or Freddie Mac guidelines. No MSR associated with conforming loans were purchased or recorded during the three and nine months ended September 30, 2012. At September 30, 2013, the principal balance of the loans associated with our MSR was \$5.58 billion.

We contract with a licensed sub-servicer to perform all servicing functions for loans associated with our MSR. The following table presents activity for MSR for the three and nine months ended September 30, 2013 and 2012.

***MSR Activity***

<b>(In Thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Balance at beginning of period	\$ 43,098	\$ 2,064	\$ 5,315	\$ -
Additions	16,677	1,241	45,291	3,849
Changes in fair value due to:				
Changes in assumptions <sup>(1)</sup>	1,353	(584)	11,665	(1,065)
Other changes <sup>(2)</sup>	(894)	(66)	(2,037)	(129)
<b>Balance at End of Period</b>	<b>\$ 60,234</b>	<b>\$ 2,655</b>	<b>\$ 60,234</b>	<b>\$ 2,655</b>

- (1) Primarily reflects changes in discount rates and prepayment assumptions due to changes in interest rates.  
(2) Reflects the impact of MSR-related cash flows received during the period.

**Note 18. Operating Expenses**

Components of our operating expenses for the three and nine months ended September 30, 2013 and 2012 are presented in the following table.

*Operating Expenses*

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Fixed compensation expense	\$ 5,808	\$ 4,412	\$ 17,498	\$ 13,820
Variable compensation expense	5,621	5,593	14,418	11,211
Equity compensation expense	1,997	2,151	7,880	7,285
Severance expense	445	-	3,879	-
<b>Total compensation expense</b>	<b>13,871</b>	<b>12,156</b>	<b>43,675</b>	<b>32,316</b>
Accounting and legal	2,066	1,251	5,118	3,734
Systems and consulting	2,780	1,225	6,839	4,648
Office costs	1,337	1,549	3,989	3,714
Other operating expenses	1,799	921	5,474	2,488
<b>Total Operating Expenses</b>	<b>\$ 21,853</b>	<b>\$ 17,102</b>	<b>\$ 65,095</b>	<b>\$ 46,900</b>

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

**September 30, 2013**

**(Unaudited)**

**Note 19. Taxes**

For the nine months ended September 30, 2013 and 2012, we recognized an expense for income taxes of \$9 million and \$1 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at September 30, 2013 and 2012.

*Reconciliation of Statutory Tax Rate to Effective Tax Rate*

	<b>2013</b>	<b>September 30, 2012</b>
Federal statutory rate	34.0 %	34.0 %
State statutory rate, net of Federal tax effect	7.2 %	7.2 %
Differences in taxable loss from GAAP income	(20.6) %	(20.4) %
Dividends paid deduction	(14.8) %	(19.6) %
<b>Effective Tax Rate</b>	<b>5.8 %</b>	<b>1.2 %</b>

During the three months ended September 30, 2013, we released a valuation allowance for capital loss carryforward deferred tax assets based on our current expectation for realizing net capital gains within the carryforward period. The benefit from income taxes recorded for the three months ended September 30, 2013, primarily resulted from the release of this valuation allowance.

We assessed our tax positions for all open tax years (Federal years 2010 to 2012, State years 2009 to 2012) and, at September 30, 2013 and December 31, 2012, concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

**Note 20. Subsequent Events**

At September 30, 2013, we had identified for purchase \$595 million of residential mortgage loans that were in various stages of the origination process with third-party originators. Some of these loans may not ultimately close and, therefore, would not be available for purchase. Since September 30, 2013, and through November 4, 2013, \$246 million of these loans closed and were purchased by us. We expect the purchase of an additional amount of these loans to occur during the fourth quarter of 2013, subject to loan availability and delivery.



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

**Introduction**

Redwood Trust, Inc., together with its subsidiaries, is an internally-managed specialty finance 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. For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust ( REIT ).

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

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in this Management's Discussion and Analysis of Financial Condition and Results of Operations, our consolidated financial statements and notes thereto, and the supplemental financial information, which are included in Part I, Items 1 and 2 of this Quarterly Report on Form 10-Q.

Our website can be found at [www.redwoodtrust.com](http://www.redwoodtrust.com). We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission ( SEC ). We also make available, free of charge, access to our charters for our Audit Committee, Compensation Committee, and Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code). In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-GAAP financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. Through the commercial section of our website, we also disclose information about our origination or acquisition of new commercial loans and other commercial investments, generally within five business days of origination or acquisition. We believe that this information may be of interest to investors in Redwood, although we may not always disclose on our website each new commercial loan or other new commercial investment we originate or acquire (or we may not disclose them on our website within the five business day period described above) due to, among other reasons, confidentiality obligations to the borrowers of those loans or counterparties to those investments. The information on our website is not part of this Quarterly Report on Form 10-Q.

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

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**Table of Contents****Cautionary Statement**

This Quarterly Report on Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as anticipate, estimate, will, should, expect, believe, intend, seek, plan and similar expressions, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 and this Quarterly Report on Form 10-Q, in each case under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) statements we make regarding Redwood's future business strategy and strategic focus, including statements relating to our confidence in our overall market position, strategy and long-term prospects, and our belief in the long-term efficiency and necessity of private label securitization as a form of U.S. mortgage financing; (ii) our expectations regarding movements in interest rates and their effect on the pace of refinance activity, including that we believe we have already seen the cyclical (possibly generational) lows in mortgage rates and that we expect a subdued level of refinance activity for an extended period of time, subject to periods of potential volatility as the Federal Reserve's quantitative easing program plays out; (iii) statements we make regarding other near-term challenges that we face, including price competition from banks for jumbo mortgages and the pace of activity in the securitization market; (iv) statements we make regarding growth opportunities for our residential business, including the expanding opportunities that we expect to see as a result of entering the conforming loan market and our positioning to be involved in risk-sharing opportunities at the originator level, to the extent those opportunities arise in the future; (v) statements we make regarding GSE reform legislation, including that the current direction of GSE reform legislation favors private capital credit providers with loan platforms, such as us, and statements we make regarding the potential size of the market opportunity that could emerge from these GSE reform efforts; (vi) statements we make regarding new loan product opportunities, including that we are exploring the acquisition and distribution (possibly through securitization) of mortgages that do not meet the technical definition of a Qualified Mortgage (QM) under the new Consumer Financial Protection Bureau (CFPB) rules that go into effect in early January 2014, and our expectation that this market segment will be underserved by lenders, as well as our cautionary statement not to expect any non-QM loan transactions in the near term; (vii) our assumptions and expectations related to a stabilizing interest rate environment, the reaction of investors in triple-A rated RMBS to securities backed by more recently originated, higher coupon mortgages, and the pace of RMBS issuance; (viii) our expectations regarding our loan sale distribution via whole loan sales and securitizations, our expectation to complete at least one securitization during the fourth quarter of 2013 and our outlook for residential loan sale profit margins, including our statement that we believe we can earn on average 25 to 50 basis points in loan sale profit margins, net of our hedges; (ix) our outlook and expectations relating to our commercial real estate platform, including statements regarding our expectations related to the total volume of senior commercial loans that we will originate in 2013, our expected loan sale margins and the expected timing of sales with respect to those loans, and the expected returns that our commercial mortgage banking activities will generate for shareholders in 2013; (x) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase or plan to purchase, including the amount of such loans that we identified for purchase during the third quarter of 2013 and at September 30, 2013, and statements relating to the volume of residential mortgage loans expected to be available for purchase during the fourth quarter of 2013; (xi) statements



relating to our estimate of our investment capacity (including that we estimate our investment capacity at September 30, 2013 to be approximately \$150 million) and our statement that we believe this level of investment capacity and liquidity should be sufficient to fund our business and investment objectives for the remainder of 2013; (xii) statements relating to the amount of equity capital we are targeting to allocate to fund commercial investments, and statements relating to the possibility of funding growth in our commercial platform with dedicated capital; (xiii) statements relating to our competitive position and our ability to compete in the future; (xiv) statements relating to future market and economic conditions and the future volume of transactions in those markets, including, without limitation, future conditions in the residential and commercial real estate markets and related financing markets, and the related potential opportunities for our residential and commercial business activity; and (xv) statements regarding our expectations and estimates relating to the characterization for income tax purposes of our dividend distributions, our expectations and estimates relating to tax accounting, tax liabilities and tax savings, and GAAP tax provisions, our estimates of REIT taxable income and TRS taxable income, and our anticipation of additional credit losses for tax purposes in future periods (and, in particular, our statement that, for tax purposes, we expect an additional \$69 million of tax credit losses on residential securities we currently own to be realized over an estimated three- to five-year period).

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Important factors, among others, that may affect our actual results include: general economic trends, the performance of the housing, commercial real estate, mortgage, credit, and broader financial markets, and their effects on the prices of earning assets and the credit status of borrowers; federal and state legislative and regulatory developments, and the actions of governmental authorities, including those affecting the mortgage industry or our business; developments related to the fixed income and mortgage finance markets and the Federal Reserve's statements regarding its future open market activity and monetary policy; our exposure to credit risk and the timing of credit losses within our portfolio; the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own; our exposure to adjustable-rate and negative amortization mortgage loans; the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks; changes in credit ratings on assets we own and changes in the rating agencies credit rating methodologies; changes in interest rates; changes in mortgage prepayment rates; the availability of assets for purchase at attractive prices and our ability to reinvest cash we hold; changes in the values of assets we own; changes in liquidity in the market for real estate securities and loans; our ability to finance the acquisition of real estate-related assets with short-term debt; the ability of counterparties to satisfy their obligations to us; our involvement in securitization transactions, the profitability of those transactions, and the risks we are exposed to in engaging in securitization transactions; exposure to claims and litigation, including litigation arising from our involvement in securitization transactions; whether we have sufficient liquid assets to meet short-term needs; our ability to successfully compete and retain or attract key personnel; our ability to adapt our business model and strategies to changing circumstances; changes in our investment, financing, and hedging strategies and new risks we may be exposed to if we expand our business activities; exposure to environmental liabilities and the effects of global climate change; failure to comply with applicable laws and regulations; our failure to maintain appropriate internal controls over financial reporting and disclosure controls and procedures; the impact on our reputation that could result from our actions or omissions or from those of others; changes in accounting principles and tax rules; our ability to maintain our status as a REIT for tax purposes; limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940; decisions about raising, managing, and distributing capital; and other factors not presently identified.

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

**Our Business**

Redwood is an internally-managed specialty finance 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. For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust ( REIT ) and we generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as the REIT or our REIT. We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as our operating subsidiaries or our taxable REIT subsidiaries or TRS . Our mortgage banking activities are generally carried out through our operating subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our operating subsidiaries, and to distribute as dividends at least 90% of the income we generate from the investment portfolio at our REIT.

Our residential mortgage banking activities primarily consist of operating a residential mortgage loan conduit i.e., the acquisition of residential mortgage loans, which we also refer to as residential loans, from third-party originators and the subsequent sale or securitization of those loans. Most of the residential loans we acquire are securitized through our Sequoia securitization program. The process of sponsoring a Sequoia securitization begins with the acquisition, on

a loan-by-loan basis (or flow basis), of residential loans originated by banks and mortgage companies located throughout the U.S., periodically augmented by our acquisition of larger pools of residential loans (or bulk acquisitions) that may be available for purchase from other participants in the capital markets for residential loan finance. Our acquisition and accumulation of these loans for securitization is generally funded with equity and short-term debt. Once a sufficient amount of residential loans has been accumulated for securitization, we pool and transfer those loans to a Sequoia securitization entity, establish a financial structure for the securitization, and the Sequoia securitization entity then issues senior and subordinate residential mortgage-backed securities ( RMBS or residential securities ) collateralized by that pool of loans. Senior securities issued by Sequoia securitization entities, or those interests that generally have the first right to cash flows and are generally last to absorb losses, are generally issued to third parties we refer to as senior investors or triple-A investors, while some or all of the remaining subordinate securities, or those interests that generally have the last right to cash flows and are generally first in line to absorb losses, are generally retained by us and held for investment at our REIT. From time to time, we may also invest in senior interest-only ( IO ) securities issued by a Sequoia securitization entity. These IO securities receive interest payments (but no principal payments) related to securitized residential mortgage loans. We may also retain mortgage servicing rights ( MSRs ) associated with residential loans transferred to a Sequoia securitization entity and invest in other MSRs associated with residential loans. The owner of an MSR is entitled to receive a portion of the interest payments from the associated residential loan

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and is obligated to directly service, or retain a sub-servicer to directly service, the associated loan. The MSR owner may also be obligated to fund advances of principal and interest payments due to a third party owner of the loan (including, for example, a securitization trust), but not received on schedule from the loan borrower. We do not originate or directly service residential loans. Residential loans for which we own the MSR are directly serviced by a licensed sub-servicer we retain.

Our commercial mortgage banking activities primarily consist of operating as a commercial real estate lender by originating mortgage loans and providing other forms of commercial real estate financing (which we also refer to generally as commercial loans) directly to borrowers and through a correspondent network of third-party brokers. We may structure commercial loans as senior or subordinate mortgage loans, as mezzanine loans, or as other forms of financing, such as preferred equity interests in special purpose entities that own commercial real estate. We typically sell the senior loans we originate to other participants in the capital markets for commercial real estate finance, primarily to third-party sponsors of commercial loan securitization entities that issue commercial mortgage-backed securities (CMBS or commercial securities). The mezzanine and subordinate commercial loans we originate are generally transferred to, and held for investment at, our REIT.

Our investment portfolio is primarily held at our REIT, and includes investments in residential securities issued in our Sequoia securitization transactions, as well as residential securities issued by third parties. Some of the securities we invest in are residential re-REMIC support securities or similar securities, which are securities that are generally created through the resecuritization of senior RMBS. Re-REMIC support securities are subordinate to, and provide credit support for, the senior re-REMIC securities issued in a resecuritization. We may also invest in other assets, securities, and instruments that are related to residential real estate. For example, in addition to investing in MSRs associated with residential loans transferred to Sequoia securitization entities, we may also invest in MSRs acquired directly from third parties. Our investment portfolio includes investments in commercial loans that are originated through our commercial mortgage banking activities and may also include investments in 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.

Our primary sources of income are net interest income from our investment portfolio and income from our mortgage banking activities. Net interest income consists of the interest income we earn less the interest expenses we incur on borrowed funds and other liabilities. Mortgage banking income consists of, among other things, the fee and gain on sale income we generate through our residential and commercial mortgage banking activities, offset by hedging costs directly associated with engaging in these activities.

Throughout our history we have sponsored or managed other investment entities, including a private limited partnership fund that we managed, the Redwood Opportunity Fund, LP (the Fund), as well as Acacia securitization entities, certain of which we continue to manage. The Fund was primarily invested in residential securities and the Acacia entities are primarily invested in a variety of real estate-related assets. We are not currently seeking to sponsor or manage other entities like the Fund or the Acacia securitization entities.

During the third quarter of 2011, we engaged in a transaction in which we resecuritized a pool of senior residential securities (the Residential Resecuritization) primarily for the purpose of obtaining permanent non-recourse financing on a portion the residential securities we hold in our investment portfolio at the REIT. Similarly, during the fourth quarter of 2012, we engaged in a transaction in which we securitized a pool of commercial loans (the Commercial Securitization) primarily for the purpose of obtaining permanent non-recourse financing on a portion of the commercial loans we hold in our investment portfolio at the REIT.

Many of the entities we have sponsored or managed are currently, or have been historically, recorded on our consolidated balance sheets for financial reporting purposes based upon applicable accounting guidance set forth by Generally Accepted Accounting Principles in the United States ( GAAP ). However, each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not, respectively, owned by us or legal obligations of ours, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities and, to the extent we hold securities issued by, or other investments in, these entities, we are exposed to the performance of these entities and the assets they hold.

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**Business Update Third Quarter 2013**

Over the past six months, we have remained profitable through a tumultuous time in the residential mortgage market, as market participants adjusted to a steep increase in mortgage rates. During these volatile six months, our book value increased to \$14.65 per share at September 30, 2013 from \$14.54 per share at March 31, 2013, while we paid \$0.56 per share in dividends, reflecting the strength of our portfolio management and mortgage pipeline risk management strategies.

Looking ahead, we believe our residential business has significant growth opportunities. The current direction of Fannie Mae and Freddie Mac (Government-Sponsored Enterprises or GSE) reform legislation favors private capital credit providers with loan platforms, such as Redwood. We believe the potential market opportunity that could emerge from these GSE reform efforts is many times the size of the opportunity in our traditional jumbo business. We are ideally positioned to take advantage of these trends by leveraging our well established residential platform to add loan sellers and new products.

Although we remain positive on our overall market position, strategy, and long-term prospects, near-term challenges remain slowing refinance activity, aggressive price competition from banks for jumbo residential mortgages, and a slowdown in the securitization market that will likely continue to impact our financial results for the remainder of 2013 and into early 2014. The mortgage business continues to remain cyclical, with changes in interest rates driving mortgage refinance activity. We believe we have already seen the cyclical (possibly generational) lows in mortgage rates, and we therefore expect a subdued level of refinance activity for an extended period of time. That said, there might be some modest pickup in refinance activity as the Federal Reserve's quantitative easing program plays out.

We have re-directed some of our resources from residential jumbo loan acquisitions toward our new GSE conforming loan initiative and other potential new loan product opportunities. A significant cost advantage of our loan acquisition model is that our loan sellers, rather than us, absorb the cost of brick and mortar branches, loan officers and other direct origination overhead. Avoiding this cost burden otherwise reduces the impact on us when cyclical slowdowns occur.

Our goal in building a residential loan platform was to have a proprietary source of mortgage banking income and to create attractive portfolio investments. We built the platform to have the flexibility and operating leverage to handle multiple sellers, loan products, and sources of distribution. We believe that what we do is hard to replicate. One of the ways we attempt to bring value to our business counterparties is through the combination and complexity of the elements necessary to execute our residential strategy. We believe these elements include the Redwood brand, a team with significant mortgage banking and capital markets experience, the right systems, relationships with investors, lenders and Wall Street, and a strong balance sheet.

Over the past year, we have worked diligently to add scalability to our Denver support operations and systems, preparing our platform for the addition of GSE loans to our product offerings. We also put considerable effort into expanding our direct whole loan distribution capabilities to supplement our securitization distribution channel. This effort proved valuable to us when the securitization market recently slowed.

We began acquiring residential GSE loans in mid-October 2013, a meaningful development in the evolution of our residential platform. Entering the market for GSE loans also enables us to create our own investments in mortgage servicing rights (MSRs) and positions us to be involved in risk-sharing opportunities at the originator level to the extent those opportunities arise in the future, consistent with the concept envisioned by the Federal Housing Finance Agency.

To further expand our product offerings, we are also exploring the acquisition and distribution (possibly through securitization) of safe, well-underwritten mortgages made to good borrowers that do not meet the technical definition of a Qualified Mortgage (QM) under the new Consumer Financial Protection Bureau rules that go into effect in early January 2014. We expect this market segment to be underserved by lenders. We would caution not to expect any non-QM loan transactions in the near term, as various participants in the mortgage chain (lenders, rating agencies, and senior residential mortgage-backed securities (RMBS) investors) need to work through and get comfortable with the regulatory and compliance risks associated with these types of loans.

Another challenge we face is loan price competition from large banks as they aggressively seek to add residential mortgages to their portfolios. During the third quarter of 2013, some banks were offering 30-year fixed-rate jumbo mortgages more than 25 basis points below GSE conforming rates, as compared to historically being offered approximately, on average, 25 basis points higher than conforming rates. We are not certain why banks would so aggressively put potentially very long duration assets on their balance sheets at this point in the interest rate cycle. We believe it is possible that excess liquidity in the banking system, together with a desire for loan and interest income growth, outweighs the potential risks from future asset/liability mismatches. It is difficult to estimate how long this condition might persist.

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Regarding residential securitization, over the long term, we firmly believe that private label securitization is a very efficient and necessary form of U.S. mortgage financing, sitting alongside government supported mortgage financing and banks' balance sheets. Through the securitization process, cash flows and the risks (duration, interest rate, credit) associated with a pool of loans can be tailored to create securities that cater to the specific risk-return preference of investors. Furthermore, it is the only way for institutional investors to easily make a residential mortgage investment by simply buying mortgage-backed securities.

Private securitization is our preferred source of loan distribution as it allows us to create attractive, internally sourced credit and interest-only investments for our portfolio. Through the 20 securitization transactions we have completed since 2010, we created over \$500 million of investments for our portfolio.

Recently, private mortgage securitization slowed down in the face of the recent rapid and steep rise in mortgage interest rates. Now that prevailing mortgage interest rates are much higher, the new expectation for the duration of securities backed by lower coupon mortgages is much longer than previous expectations. Investors are currently demanding more yield (lower prices) to compensate for additional duration risk. The GSE securities market is well established, deep and liquid; the private label securities market currently is nascent, thin, and relatively illiquid. As a consequence, the negative impact on valuations for newly issued private label securities was more severe than for comparable GSE securities.

Despite the difficult private label market conditions, we completed three securitizations in the third quarter of 2013. These securitizations, together with our direct whole loan sales, enabled us to substantially reduce our exposure to lower coupon residential mortgages in our residential mortgage pipeline.

Going forward, assuming interest rates remain relatively stable, we expect investors in triple-A rated RMBS to view securities backed by more recently originated, higher coupon mortgages more favorably from a pricing standpoint, which should help increase the RMBS issuance market. In the near-term, until the markets restabilize, we expect our loan sale distribution to be a combination of direct whole loan sales and securitizations. We expect to complete at least one securitization transaction in the fourth quarter of 2013. We believe that based on these distribution outlets and our ability to adjust loan pricing to our sellers, we can earn on average 25 to 50 basis points in loan sale profit margins, net of our hedges.

Turning to our strategy for our commercial platform, we have successfully shifted our focus to originating senior commercial loans, while continuing to originate mezzanine loans. While we will likely fall short of our full year goal to originate \$1 billion of senior loans, our overall commercial loan sale margins have exceeded our expectations. Given these results, we are optimistic that our commercial mortgage banking activities will generate attractive returns for shareholders in 2013.

To date, we have generally capped Redwood's investment in our commercial platform at \$300 million. We are currently considering alternatives to fund its continued growth and success with dedicated capital, which could take on a variety of different forms. How we ultimately move forward with our commercial platform will be based on what we believe is in the best long-term interests of our shareholders.

Heading into 2014, we are positive about Redwood's strategic positioning. We are in the right businesses and we have an excellent team of professionals to capitalize on opportunities. We feel that near-term challenges are starting to subside as mortgage rates stabilize, and we are enthusiastic about the expanding opportunities we expect to see as a result of entering the GSE conforming loan market.

## **Financial Results Third Quarter 2013**



Redwood generated positive results for the third quarter of 2013 despite continuing headwinds driven by interest rate volatility and investor uncertainty. Our focus remained on managing the liquidity of our residential loan pipeline during the quarter while also making tangible progress on a few key operating initiatives. We ended the third quarter profitably, with significantly reduced exposure to lower coupon residential mortgages in our pipeline, as well as excess capital to invest. Quarterly highlights include the following:

We earned \$0.25 per share for the third quarter of 2013. As noted in our Quarterly Report on Form 10-Q for the second quarter of 2013, our third quarter GAAP earnings include approximately \$0.17 per share of negative market valuation adjustments related to residential loans in our pipeline at June 30, 2013. We were successful in distributing nearly all of these loans in the third quarter of 2013, resulting in a small economic profit relating to these loans after factoring in our hedges.

Our GAAP book value at September 30, 2013 was \$14.65 per share, down \$0.04 per share from June 30, 2013. The reduction in book value reflects the anticipated adverse impact of \$0.17 per share of negative market valuation adjustments for loans we had identified but not yet purchased at June 30, 2013, which we anticipated and described in our Quarterly Report on Form 10-Q for the second quarter of 2013.

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We completed three residential securitizations totaling \$1.2 billion, and created \$80 million of securities and \$13 million of investments in mortgage servicing rights for our investment portfolio. Additionally, we completed whole loan sales totaling \$600 million.

For the residential loans we identified for purchase in the third quarter of 2013, we expect to realize loan sale profit margins of 25 to 50 basis points, consistent with our long-term expectation for the profitability of our loan sale activities.

We acquired \$1.3 billion of loans in the third quarter of 2013, as compared to \$2.6 billion in the second quarter of 2013. In total, we have purchased \$6.5 billion loans through the first three quarters of 2013. At September 30, 2013, we owned \$728 million of residential loans and had identified an additional \$595 million for purchase.

We added 11 residential loan sellers to our platform in the third quarter of 2013, increasing the total number of active sellers to 112 at September 30, 2013.

We originated 12 senior commercial loans totaling \$113 million and we sold 18 senior commercial loans totaling \$238 million in the third quarter of 2013. We also originated two mezzanine loans for \$9 million in the third quarter of 2013.

We declared and distributed a \$0.28 per share dividend to shareholders for the third quarter of 2013. We deployed \$146 million of capital into new investments in the third quarter of 2013 down from \$159 million in the second quarter of 2013, as summarized in the following table.

**Table 1 Quarterly Investment Activity**

(In Millions)	Three Months Ended	
	September 30, 2013	June 30, 2013
Residential investments		
Sequoia RMBS	\$ 80	\$ 124
Third-Party RMBS	143	-
Less: Short-term debt	(101)	-
MSR Investments	17	16
Net residential investments	139	140
Commercial investments	9	19
Less: Borrowings	(2)	-
Net commercial investments	7	19

<b>Equity Capital Invested</b>	\$	146	\$	159
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Our securities acquisitions in the third quarter included \$80 million of residential securities retained from the \$1.2 billion of Sequoia securitizations we completed during the third quarter. These residential securities included \$72 million of subordinate securities (AA, A, BBB, BB and non-rated securities) and \$9 million of interest-only securities. We also acquired \$143 million of third-party RMBS in the third quarter of 2013, consisting of \$100 million of seasoned senior securities and \$42 million of new issue subordinate securities from three issuers.

### ***Residential Investments***

At September 30, 2013, our residential securities portfolio had a market value of \$1.3 billion, consistent with the market value of this portfolio at June 30, 2013. We acquired \$223 million of securities in the third quarter, which was largely offset by sales of \$182 million and principal payments of \$38 million. Negative valuation adjustments for the third quarter of 2013 were \$3 million.

Following the end of the third quarter of 2013 through November 1st, we deployed \$35 million of capital, net of financing, into investments in residential securities. This included \$17 million invested in newly issued third party subordinate securities as well as \$190 million invested in seasoned senior securities which we financed with a combination of \$172 million of short-term debt and \$18 million of equity capital.

At September 30, 2013, the market value of our mortgage servicing rights (MSRs) portfolio was \$60 million, or 1.08% of the \$5.6 billion principal amount of the associated mortgage loans. This included \$13 million of MSRs associated with \$1.6 billion of loans we acquired in the third quarter of 2013 through our conduit operations and \$3 million of MSRs acquired in the third quarter of 2013 associated with a \$300 million pool of conforming loans.

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### ***Residential Mortgage Banking Activities***

#### *Recent Market Conditions*

Interest rate volatility in recent months resulted in a setback for the new-issue RMBS market. Industry-wide, there was \$3.5 billion of new issuance in the third quarter of 2013, down from \$4.4 billion in the second quarter of 2013. There were five securitizations completed in July, two securitizations completed in August, and only one securitization completed in September. Redwood sponsored three of these eight securitizations. With the fixed income market expecting an eventual tapering of the Federal Reserve's demand for Agency MBS, and fixed income funds continuing to experience outflows, it is likely to be a quiet fourth quarter for new-issuance RMBS.

Despite the slowdown in the securitization market, there has been a strong demand among large banks for originating and acquiring prime quality jumbo mortgages.

As a result of this demand, the whole loan distribution component of our conduit platform has been very active in recent quarters. We sold over \$900 million in whole loans through the first three quarters of 2013, and we expect to remain an active participant in the whole loan market to take advantage of the best loan sale execution opportunities available to us going forward.

#### *Quarterly Update*

We completed three Sequoia securitizations totaling \$1.2 billion in the third quarter of 2013, as compared to four securitizations totaling \$1.8 billion in the second quarter of 2013. We also completed \$600 million of whole loan sales in the third quarter, as compared to \$286 million in the second quarter. In October 2013, we settled \$325 million in whole loan sales and we expect to close an approximate \$325 million securitization in November 2013.

With mortgage rates increasing, we began acquiring additional 15-year fixed-rate and hybrid loans. Of the \$1 billion of loans we identified for purchase in the third quarter of 2013, 55% were 30-year fixed rate mortgage loans, down from 83% in the second quarter of 2013, and 95% from the third quarter of 2012. Additionally, of the \$1 billion of loans we identified for purchase in the third quarter of 2013, 46% were refinance-related, down from 53% in the second quarter of 2013.

Our third quarter loan acquisition volume was \$1.3 billion, as compared to \$2.6 billion in the second quarter of 2013. The decline resulted from the approximate 100 basis point increase in mortgage rates that led to an overall decline in industry loan originations, particularly for refinance-related loans. We currently expect to acquire between \$500 million and \$1 billion of jumbo residential loans in the fourth quarter of 2013. Given the volatility observed in the market, it is still not clear whether we will reach \$8 billion of jumbo residential loan purchases—one of the goals we established earlier in the year for 2013.

As described in the Recent Market Conditions section, the volume of loans we have identified for purchase and our acquisitions in recent months have been impacted by highly aggressive pricing of jumbo mortgage loans by large banks. Despite the competitive environment, we have continued to acquire loans, at a slower pace, from a growing number of sellers. At September 30, 2013, our 112 sellers consisted of 53 regional banks (or their subsidiaries) and 59 mortgage companies, located throughout the U.S.

### ***Commercial Mortgage Banking Activities***

Our third quarter of 2013 commercial loan origination volume was also impacted by the volatility in interest rates during the quarter. We funded 12 senior commercial loans totaling \$113 million in the third quarter, as compared to the second quarter of 2013 when we funded ten loans totaling \$150 million. We sold 18 senior loans totaling \$238 million in the third quarter of 2013, as compared to six senior loans totaling \$74 million in the second quarter of 2013.

Our commercial mortgage banking activities generated income of \$3 million in the third quarter of 2013, as compared to \$6 million in the second quarter of 2013. At September 30, 2013, we had \$27 million of senior commercial loans held for sale, all of which we expect to sell by mid-November 2013. For the first nine months ended September 30, 2013, we originated \$562 million of senior commercial loans, including those that were table-funded by third parties. While we expect to originate approximately \$200 to \$300 million of senior loans in the fourth quarter of 2013, we are likely to fall short of our full year goal of originating \$1 billion of senior commercial loans in 2013.

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Commercial mezzanine loan originations in the third quarter of 2013 totaled two loans for \$9 million, as compared to six loans for \$19 million in the second quarter of 2013. This brought our portfolio of non-securitized mezzanine loans to 21 for \$84 million at September 30, 2013. Our securitized mezzanine portfolio totaled \$270 million at September 30, 2013 and June 30, 2013. Redwood's investment in this securitized portfolio totaled \$115 million at the end of the third quarter of 2013.

**Summary of Results of Operations****Net Income**

Our reported GAAP net income was \$22 million (\$0.25 per share) and \$148 million (\$1.65 per share), respectively, for the three and nine months ended September 30, 2013, as compared to \$40 million (\$0.48 per share) and \$90 million (\$1.09 per share), respectively, for the three and nine months ended September 30, 2012. The following table presents the components of our GAAP net income for the three and nine months ended September 30, 2013 and 2012.

**Table 2 Net Income**

(In Thousands, Except Share Data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Interest income	\$ 57,420	\$ 59,723	\$ 168,664	\$ 177,988
Interest expense	(21,833)	(28,285)	(61,651)	(87,822)
Net interest income	35,587	31,438	107,013	90,166
Provision for loan losses	(1,727)	(1,319)	(493)	(254)
Other market valuation adjustments, net	462	957	(6,099)	(402)
<b>Net interest income after provision and other market valuation adjustments</b>	<b>34,322</b>	<b>31,076</b>	<b>100,421</b>	<b>89,510</b>
Mortgage banking activities, net	(5,944)	12,303	98,608	13,642
Operating expenses	(21,853)	(17,102)	(65,095)	(46,900)
Realized gains, net	10,469	13,940	23,291	34,555
Benefit from (provision for) income taxes	4,935	(516)	(9,113)	(1,116)
<b>Net Income</b>	<b>\$ 21,929</b>	<b>\$ 39,701</b>	<b>\$ 148,112</b>	<b>\$ 89,691</b>
Diluted weighted average common shares outstanding	84,422,039	80,764,380	93,233,865	80,175,660
Net earnings per share	\$ 0.25	\$ 0.48	\$ 1.65	\$ 1.09

The *Results of Operations and Financial Condition* section of this *Management's Discussion and Analysis of Financial Condition and Results of Operations* contains a detailed analysis of the components of our GAAP net income.



**Table of Contents*****Net Interest Income after Provision and Other Market Valuation Adjustments***

Net interest income after provision and other MVA was \$34 million for the third quarter of 2013, as compared to \$31 million for the third quarter of 2012, an increase of \$3 million. This increase was primarily attributable to an increase in net interest income at Redwood driven by higher average balances of residential and commercial loans and trading securities. This increase was partially offset by lower yields on the earning assets that were financed with a larger portion of debt at a slightly higher debt yield. A significant decline in average earning assets and liabilities at Consolidated Entities resulting from the deconsolidation of Sequoia and Acacia securitizations in late 2012 did not materially affect net interest income as the deconsolidated entities earned minimal or in some cases negative net interest income. The following table details the components of other MVA for the three and nine months ended September 30, 2013 and 2012.

***Table 3 Components of Other MVA***

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Residential loans, at lower of cost or fair value	\$ (11)	\$ 90	\$ 68	\$ 572
Commercial loans, at fair value	-	11	-	134
Trading securities	540	35,099	(4,168)	84,923
Impairments on AFS securities	-	(1,207)	(1,666)	(1,842)
REO	(76)	(220)	(407)	(364)
Other derivative instruments, net	9	(4,649)	74	(10,632)
ABS issued - Acacia	-	(28,167)	-	(73,193)
<b>Total Other MVA, Net</b>	<b>\$ 462</b>	<b>\$ 957</b>	<b>\$ (6,099)</b>	<b>\$ (402)</b>

***Mortgage Banking Activities, Net***

Mortgage banking activities, net, include valuation changes of residential and commercial loans and MSR, valuation changes related to derivatives and Sequoia IO securities used in part to offset risks associated with our mortgage banking activities, gains from mortgage loan sales and securitizations, and net income from MSR. The following table presents the components of mortgage banking activities, net, for the three and nine months ended September 30, 2013 and 2012.

***Table 4 Components of Mortgage Banking Activities, net***

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net market valuation adjustments on:				
Residential loans	\$ (10,804)	\$ 14,976	\$ (17,339)	\$ 14,992
Commercial loans	3,171	-	2,826	-
MSRs	460	(650)	9,628	(1,194)



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Sequoia IO securities	(1,866)	(4,427)	36,399	(9,101)
Risk management derivatives	442	(2,385)	51,010	(8,784)
Net gains on residential loan sales and securitizations	-	4,611	-	17,447
Net gains on commercial loan sales and originations	-	-	11,031	-
Income from MSRs, net	2,653	178	5,053	282
<b>Total Mortgage Banking Activities, Net</b>	<b>\$ (5,944)</b>	<b>\$ 12,303</b>	<b>\$ 98,608</b>	<b>\$ 13,642</b>

Income from mortgage banking activities, net, was negative \$6 million for the third quarter of 2013, primarily reflecting losses realized on loans we had identified at June 30, 2013, but purchased in the third quarter of 2013. As previously discussed, our results for the second quarter of 2013 included hedging gains associated with these loans, but did not reflect the corresponding negative market valuation adjustments for the loans themselves. At September 30, 2013, over 85% of these loans were sold or securitized with nearly all of the remainder having been purchased and marked-to-market through our income statement. In aggregate, market valuation adjustments recorded in the third quarter of 2013 associated with our residential loan pipeline at June 30, 2013, were negative \$15 million or \$0.17 per share, down from our August 1, 2013, estimate of negative \$21 million or \$0.22 per share.

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Market valuation adjustments for risk management derivatives and Sequoia IO securities were more muted during the third of 2013 as interest rates stabilized. This resulted in an aggregate negative market valuation adjustment of \$1 million for the third quarter of 2013, as compared to positive \$86 million during the second quarter of 2013, when interest rates rose sharply.

Income from mortgage banking activities in the third quarter of 2013 also included \$3 million in positive market valuation gains on senior commercial loans and related derivatives, as compared to \$6 million in the second quarter of 2013.

Our loan sale profit margins are measured over the period from which we identify a loan for purchase and subsequently sell or securitize the loan. These profit margins may encompass positive or negative market valuation adjustments on loans, hedging gains or losses associated with our loan pipeline, and any other related transactional expenses, and may be realized over the course of one or more quarters for financial reporting purposes.

For loans we have identified for purchase since June 30, 2013, we expect to earn, on average, profit margins of 25 to 50 basis points as we accumulate and distribute them through whole loan sales or securitization transactions.

**Realized Gains, Net**

The following table details the components of realized gains, net, for the three and nine months ended September 30, 2013 and 2012.

**Table 5 Realized Gains, Net**

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net gains on sales of real estate securities	\$ 10,318	\$ 13,920	\$ 22,548	\$ 27,093
Net gains on calls of real estate securities	-	-	333	113
Net gains on sales of commercial mortgage loans	-	-	210	-
Net gains on extinguishment of debt	151	20	200	339
Gain on deconsolidation	-	-	-	7,010
<b>Total Realized Gains, Net</b>	<b>\$ 10,469</b>	<b>\$ 13,940</b>	<b>\$ 23,291</b>	<b>\$ 34,555</b>

Realized gains, net, were \$10 million for the third quarter of 2013, a \$4 million decrease from the third quarter of 2012. During the third quarter of 2013, we sold \$159 million of residential available-for-sale ( AFS ) securities for a net gain of \$10 million.

### ***Operating Expenses***

Operating expenses were \$22 million during the third quarter of 2013, an increase of \$5 million from the third quarter of 2012. The increase was primarily due to an increase in fixed compensation costs, systems, and other expenses resulting from the continued expansion of our residential and commercial mortgage operations. Since the beginning of 2013, we have increased our headcount by 51 new employees, bringing our total to 138 as of September 30, 2013.

### ***Tax Provision***

We recorded a \$5 million tax benefit for the third quarter of 2013, compared to a \$3 million tax provision for the second quarter of 2013. The benefit recorded in the current quarter was primarily driven by a reduction in our estimated annual effective tax rate (ETR) due to a reduction of a valuation allowance. During the third quarter of 2013, we reduced the valuation allowance for capital loss carryforward deferred tax assets that were accumulated during past periods. We now expect to utilize this deferred tax asset within the carryforward period based on our revised expectation for realizing net capital gains on sales of appreciated securities.

### ***Estimated Taxable Income for Federal Tax Purposes***

Our estimated total taxable income was \$46 million (\$0.56 per share) for the third quarter of 2013, as compared to taxable income of \$17 million (\$0.21 per share) for the third quarter of 2012. Our estimated REIT taxable income was \$20 million (\$0.24 per share) for the third quarter of 2013, as compared to REIT taxable income of \$15 million (\$0.19 per share) for the third quarter of 2012. Total realized credit losses on our investments for the third quarters of 2013 and 2012 were \$3 million (\$0.03 per share) and \$6 million (\$0.07 per share), respectively, for tax purposes. The *Results of Operations Taxable Income* section of this *Management's Discussion and Analysis of Financial Condition and Results of Operations* contains a detailed analysis of our tax results and distributions to shareholders.

**Table of Contents*****Summary of Financial Condition, Capital Resources, and Liquidity***

At September 30, 2013, our total capital was \$1.6 billion, including \$1.2 billion of shareholders' equity and \$427 million of long-term debt. We use our capital to invest in earning assets, meet lender capital requirements, and fund our operations and working capital needs. At September 30, 2013, our cash amounted to \$205 million and our current investment capacity (defined as the approximate amount of capital we have readily available for long-term investments) was estimated to be approximately \$150 million. We ended the third quarter of 2013 with short-term warehouse debt of \$467 million, which was used to finance residential and commercial loans, and had additional uncommitted borrowing capacity of \$1.3 billion under existing warehouse lines of credit to finance additional residential and commercial loans. Our short-term debt used to finance securities was \$371 million.

We had \$194 million of capital invested in commercial loan assets at September 30, 2013, which included \$27 million of senior loans held for sale. As we have noted previously, we are targeting to allocate up to \$300 million of equity capital to fund commercial investments, although our allocation could exceed that amount from time to time in anticipation of asset sales or other transactions.

We currently believe that our available capital and liquidity is sufficient to fund our business and investment objectives for the remainder of 2013. To the extent we need additional incremental capital to fund our operations and investment activities, our approach to raising capital will continue to be based on what we believe to be in the best long-term interests of our shareholders. Any future capital raising transaction could include the issuance of debt or equity securities under the shelf registration statement we currently have on file with the SEC or the issuance of similar or other types of securities in public or private offerings, including the possibility of raising dedicated capital for our commercial platform. The issuance of any securities will depend on future market conditions, funding needs and other factors and there can be no assurance that any such issuance will occur or be successful.

***Changes in Book Value***

The following table presents the changes in GAAP book value per share for the three months ended September 30, 2013 and June 30, 2013.

***Table 6 Changes in GAAP Book Value per Share***

(In Dollars, per share basis)	Three Months Ended	
	September 30, 2013	June 30, 2013
Beginning book value per share	\$ 14.69	\$ 14.54
Net income	0.25	0.71
Changes in unrealized gains/losses, net	(0.09)	(0.46)
Unrealized gains on hedges, net	0.05	0.17
Equity issuance	-	0.06
Other, net	0.03	(0.05)
Dividends	(0.28)	(0.28)
<b>Ending Book Value per Share</b>	<b>\$ 14.65</b>	<b>\$ 14.69</b>

***Investments in Consolidated Entities***

The estimated carrying value of our investments in the Sequoia securitization entities totaled \$82 million, or 7% of our equity capital, at September 30, 2013. The carrying value reflects the estimated book value of our retained investments in these entities, based on the difference between the consolidated assets and liabilities of the entities in the aggregate according to their GAAP carrying amounts. During the third quarter of 2013, cash flow generated by our investments in these entities totaled \$5 million.

We recognized net income of \$1 million in the third quarter of 2013 from our investments in consolidated Sequoia entities, as compared to net income of \$6 million in the second quarter of 2013. This decrease is primarily attributable to the reversal of provision for loan losses at Sequoia entities in the second quarter of 2013.

**Table of Contents****Real Estate Securities**

At September 30, 2013, the fair value of the residential securities we own totaled \$1.33 billion, consisting of \$481 million in prime senior securities, \$204 million in non-prime senior securities, \$156 million of re-REMIC securities, and \$483 million in subordinate securities. The following table presents the components of fair value (which equals GAAP carrying value) for real estate securities at Redwood at September 30, 2013. We categorize our securities by portfolio vintage (the years the securities were issued), by priority of cash flows (senior, re-REMIC, and subordinate), and by quality of underlying loans (prime and non-prime).

**Table 7 Securities at Redwood by Vintage and as a Percentage of Total Securities <sup>(1)</sup> <sup>(2)</sup>**

September 30, 2013	2004 & Earlier		2005		2006 - 2008		2012 - 2013		Total	% of Total Securities	
Prime	\$	5	\$	264	\$	92	\$	120	\$	481	36
Non-Prime		84		115		5		-		204	16
Senior		89		379		97		120		685	52
REMIC		-		64		93		-		156	12
Subordinate		43		14		1		425		483	36
Non-Subordinate		43		14		1		425		483	36
<b>Total Securities at Redwood</b>	<b>\$</b>	<b>132</b>	<b>\$</b>	<b>457</b>	<b>\$</b>	<b>191</b>	<b>\$</b>	<b>545</b>	<b>\$</b>	<b>1,325</b>	<b>100</b>

(1) Table may not foot due to rounding.

(2) We financed our holdings of residential securities with a combination of short-term debt secured by securities, through the Residential Resecuritization, and with long-term debt and equity capital. During the third quarter of 2013, average short-term debt secured by securities was \$350 million and the average asset-backed securities in the Residential Resecuritization was \$118 million. The securities and interests that we acquired from the Residential Resecuritization entity (which are eliminated for consolidation purposes) were \$148 million at September 30, 2013. As a result, to adjust at September 30, 2013 for the legal and economic interests that resulted from the Residential Resecuritization, total residential senior securities would be decreased by \$276 million to \$409 million, total re-REMIC residential securities would be increased by \$148 million to \$305 million, and total residential securities would be reduced by \$128 million to \$1.20 billion.

During the third quarter of 2013, our securities portfolio increased \$10 million to \$1.33 billion. This increase was attributable to \$223 million of acquisitions partially offset by \$182 million of sales, \$38 million from the effect of principal repayments and a \$3 million decrease in the value of our entire securities portfolio. Our third quarter of 2013

acquisitions included \$113 million of prime senior securities and \$110 million of prime subordinate securities.

### *Derivatives*

At September 30, 2013, we had net derivative liabilities of \$28 million, as compared with net derivative liabilities of \$48 million at December 31, 2012. We are party to interest rate swaps, interest rate swaptions, TBA contracts sold, net, and financial futures that we generally utilize to (i) manage risks associated with residential and commercial loans we own or plan to acquire and securitize or sell; and, (ii) fix the interest expense related to our long-term debt and other liabilities. The following table presents the aggregate fair value of derivative financial instruments held at Redwood at September 30, 2013 and December 31, 2012.

*Table 8 Derivatives*

(In Millions)	September 30, 2013		December 31, 2012	
	Fair Value	Notional Amount	Fair Value	Notional Amount
Risk management derivatives, net				
Residential	\$ (3)	\$ 1,233	\$ 2	\$ 1,064
Commercial	(1)	26	(1)	249
Cash flow hedges on TruPS	(24)	140	(49)	140
<b>Total Derivative Financial Instruments, Net</b>	<b>\$ (28)</b>	<b>\$ 1,399</b>	<b>\$ (48)</b>	<b>\$ 1,453</b>

The notional value of risk management derivatives associated with our residential and commercial mortgage banking activities fluctuates throughout each quarter as residential loans are identified and purchased and commercial loans are originated and each are subsequently sold or securitized. Net changes in the fair value of risk management derivatives are reflected in our income statement in

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Mortgage Banking Activities, net. Although the notional and fair value of risk management derivatives were consistent at September 30, 2013 and December 31, 2013, volatility in benchmark interest rates during the nine months ended September 30, 2013, resulted in net valuation gains from risk management derivatives of less than \$1 million and \$51 million for the three and nine months ended September 30, 2013.

Rising benchmark interest rates during 2013 resulted in a \$20 million reduction to our derivative liability related to cash flow hedges on our long-term debt. Changes in the fair value of our cash flow hedges were recorded in shareholders' equity through accumulated other comprehensive income.

**Unrealized Gains and Losses on Real Estate Securities and Derivatives**

At September 30, 2013, we had net unrealized gains of \$115 million recorded to accumulated other comprehensive income, a component of stockholders' equity, a \$23 million decrease from the net unrealized gains of \$138 million at December 31, 2012. The following table presents the activity related to unrealized gains and losses on securities and derivatives for the nine months ended September 30, 2013.

**Table 9 Accumulated Other Comprehensive Income Recognized in Stockholders' Equity**

(in Millions)	Senior	Residential Re-REMIC	Subordinate	Commercial	Derivatives	Total
Beginning Balance - December 31, 2012	\$ 89	\$ 64	\$ 21	\$ 12	\$ (48)	\$ 138
OTTI recognized in OCI	-	-	-	-	-	-
Net unrealized loss on real estate securities	(22)	(10)	(4)	(12)	-	(48)
Net unrealized gain on interest rate agreements	-	-	-	-	25	25
Reclassification: OTTI to net income	-	-	-	-	-	-
Net unrealized loss on interest rate agreements to net income	-	-	-	-	-	-
Ending Balance - September 30, 2013	\$ 67	\$ 54	\$ 17	\$ -	\$ (23)	\$ 115

A significant aspect of our ongoing risk management activities entails managing the interest-rate exposure on a portion of our long-term debt. Changes in the values of derivatives designated as cash flow hedges used to offset changes in future payment obligations are currently recorded - to the extent effective - through our consolidated balance sheet and not our consolidated income statement. The increase in benchmark interest rates during the third quarter of 2013 caused a \$4 million increase in the value of these derivatives.

**Results of Operations and Financial Condition**



The following tables present the results of Redwood (Parent) and other Consolidated Entities in order to supplement our consolidated GAAP results for the three and nine months ended September 30, 2013 and 2012. These tables do not represent separate business segments, as we manage and evaluate our business as one reportable unit. Rather, they are intended to separate the accounts of certain independent securitization entities that are bankruptcy-remote from us and from each other but for which we are still required to consolidate for financial reporting purposes. They have been structured such that Redwood's obligations are not liabilities of the consolidated entities and the liabilities of the consolidated entities are not legal obligations of Redwood.

**Table of Contents****Table 10 Consolidating Income Statements**

(In Thousands)	Three Months Ended September 30, 2013		
	Redwood (Parent) <sup>(1)</sup>	Consolidated Entities	Redwood Consolidated
Interest income	\$ 49,586	\$ 7,834	\$ 57,420
Interest expense	(15,627)	(6,206)	(21,833)
<b>Net interest income</b>	<b>33,959</b>	<b>1,628</b>	<b>35,587</b>
Provision for loan losses	(843)	(884)	(1,727)
Other market valuation adjustments, net	538	(76)	462
<b>Net interest income after provision and other market valuation adjustments</b>	<b>33,654</b>	<b>668</b>	<b>34,322</b>
Mortgage banking activities, net	(5,944)	-	(5,944)
Operating expenses	(21,802)	(51)	(21,853)
Realized gains, net	10,318	151	10,469
Net income before provision for taxes	16,226	768	16,994
Benefit for income taxes	4,935	-	4,935
<b>Net Income</b>	<b>\$ 21,161</b>	<b>\$ 768</b>	<b>\$ 21,929</b>

(In Thousands)	Three Months Ended September 30, 2012		
	Redwood (Parent) <sup>(1)</sup>	Consolidated Entities	Redwood Consolidated
Interest income	\$ 36,406	\$ 23,317	\$ 59,723
Interest expense	(6,291)	(21,994)	(28,285)
<b>Net interest income</b>	<b>30,115</b>	<b>1,323</b>	<b>31,438</b>
Provision for loan losses	(506)	(813)	(1,319)
Other market valuation adjustments, net	(1,534)	2,491	957
<b>Net interest income after provision and market valuation adjustments</b>	<b>28,075</b>	<b>3,001</b>	<b>31,076</b>
Mortgage banking activities, net	12,303	-	12,303
Operating expenses	(17,075)	(27)	(17,102)
Realized gains, net	13,920	20	13,940
Net income before provision for taxes	37,223	2,994	40,217
Provision for income taxes	(516)	-	(516)
<b>Net Income</b>	<b>\$ 36,707</b>	<b>\$ 2,994</b>	<b>\$ 39,701</b>



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(In Thousands)	Nine Months Ended September 30, 2013		
	Redwood (Parent) <sup>(1)</sup>	Consolidated Entities	Redwood Consolidated
Interest income	\$ 141,976	\$ 26,688	\$ 168,664
Interest expense	(41,422)	(20,229)	(61,651)
<b>Net interest income</b>	100,554	6,459	107,013
(Provision for) reversal of provision for loan losses	(2,419)	1,926	(493)
Other market valuation adjustments, net	(5,692)	(407)	(6,099)
<b>Net interest income after provision and other market valuation adjustments</b>	92,443	7,978	100,421
Mortgage banking activities, net	98,608	-	98,608
Operating expenses	(64,937)	(158)	(65,095)
Realized gains, net	23,091	200	23,291
Net income before provision for taxes	149,205	8,020	157,225
Provision for income taxes	(9,113)	-	(9,113)
<b>Net Income</b>	\$ 140,092	\$ 8,020	\$ 148,112

(In Thousands)	Nine Months Ended September 30, 2012		
	Redwood (Parent) <sup>(1)</sup>	Consolidated Entities	Redwood Consolidated
Interest income	\$ 103,038	\$ 74,950	\$ 177,988
Interest expense	(17,770)	(70,052)	(87,822)
<b>Net interest income</b>	85,268	4,898	90,166
(Provision for) reversal of provision for loan losses	(1,156)	902	(254)
Other market valuation adjustments, net	(3,500)	3,098	(402)
<b>Net interest income after provision and market valuation adjustments</b>	80,612	8,898	89,510
Mortgage banking activities, net	13,642	-	13,642
Operating expenses	(46,772)	(128)	(46,900)
Realized gains, net	27,206	7,349	34,555
Net income before provision for taxes	74,688	16,119	90,807
Provision for income taxes	(1,116)	-	(1,116)
<b>Net Income</b>	\$ 73,572	\$ 16,119	\$ 89,691

(1) For the three and nine months ended September 30, 2013 and 2012, the consolidating income statements present the income generated and expense incurred by the Residential Resecuritization and Commercial Securitization entities under Redwood (Parent).

At September 30, 2013, 40% of our consolidated assets and 52% of our consolidated liabilities were owned at consolidated Sequoia entities. The following table presents the components of our consolidating balance sheet at September 30, 2013.

**Table of Contents****Table 11 Consolidating Balance Sheets****September 30, 2013**

<b>(In Thousands)</b>	<b>Redwood (Parent) <sup>(1)</sup></b>	<b>Consolidated Entities</b>	<b>Redwood Consolidated</b>
Residential loans	\$ 727,879	\$ 1,864,653	\$ 2,592,532
Commercial loans	379,853	-	379,853
Real estate securities, at fair value:			
Trading securities	130,854	-	130,854
Available-for-sale securities	1,193,824	-	1,193,824
Mortgage servicing rights, at fair value	60,234	-	60,234
Cash and cash equivalents	204,646	-	204,646
<b>Total earning assets</b>	<b>2,697,290</b>	<b>1,864,653</b>	<b>4,561,943</b>
Other assets	88,613	8,960	97,573
<b>Total Assets</b>	<b>\$ 2,785,903</b>	<b>\$ 1,873,613</b>	<b>\$ 4,659,516</b>
Short-term debt			
Mortgage loan warehouse debt	\$ 467,098	\$ -	\$ 467,098
Security repurchase facilities	371,201	-	371,201
Other liabilities	79,455	1,322	80,777
Asset-backed securities issued	270,978	1,790,687	2,061,665
Long-term debt	471,605	-	471,605
<b>Total liabilities</b>	<b>1,660,337</b>	<b>1,792,009</b>	<b>3,452,346</b>
Stockholders equity	1,125,566	81,604	1,207,170
<b>Total Liabilities and Equity</b>	<b>\$ 2,785,903</b>	<b>\$ 1,873,613</b>	<b>\$ 4,659,516</b>

**December 31, 2012**

<b>(In Thousands)</b>	<b>Redwood (Parent) <sup>(1)</sup></b>	<b>Consolidated Entities</b>	<b>Redwood Consolidated</b>
Residential loans	\$ 562,658	\$ 2,272,812	\$ 2,835,470
Commercial loans	313,010	-	313,010
Real estate securities, at fair value:			
Trading securities	33,172	-	33,172
Available-for-sale securities	1,075,581	-	1,075,581
Mortgage servicing rights, at fair value	5,315	-	5,315

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Cash and cash equivalents	81,080	-	81,080
Total earning assets	2,070,816	2,272,812	4,343,628
Other assets	88,592	11,878	100,470
<b>Total Assets</b>	<b>\$ 2,159,408</b>	<b>\$ 2,284,690</b>	<b>\$ 4,444,098</b>
Short-term debt	\$ 551,918	\$ -	\$ 551,918
Other liabilities	80,472	2,103	82,575
Asset-backed securities issued	336,460	2,193,481	2,529,941
Long-term debt	139,500	-	139,500
Total liabilities	1,108,350	2,195,584	3,303,934
Stockholders equity	1,051,058	89,106	1,140,164
<b>Total Liabilities and Equity</b>	<b>\$ 2,159,408</b>	<b>\$ 2,284,690</b>	<b>\$ 4,444,098</b>

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(1) The consolidating balance sheet presents the assets and liabilities of the Residential Resecuritization and Commercial Securitization under Redwood (Parent), although these assets and liabilities are owned by their respective entities and are legally not ours and we own only the securities and interests that we acquired from these entities. At September 30, 2013 and December 31, 2012, the Residential Resecuritization accounted for \$276 million and \$326 million, respectively, of available-for-sale real estate securities and other assets and \$112 million and \$165 million, respectively, of asset-backed securities issued and other liabilities. At September 30, 2013 and December 31, 2012, the Commercial Securitization accounted for \$271 million and \$290 million, respectively, of commercial loans held-for-investment and other assets and \$159 million and \$173 million, respectively, of asset-backed securities issued and other liabilities.



**Table of Contents****Results of Operations Redwood (Parent)****Net Interest Income after Provision and Other MVA at Redwood (Parent)**

Net interest income after provision and other MVA at Redwood was \$34 million and \$28 million for the three months ended September 30, 2013 and 2012, respectively. Net interest income after provision and other MVA at Redwood was \$92 million and \$81 million for the nine months ended September 30, 2013 and 2012, respectively. The following tables present the components of net interest income after provision and other MVA at Redwood for the three and nine months ended September 30, 2013 and 2012.

**Table 12 Net Interest Income after Other MVA at Redwood (Parent)**

(Dollars in Thousands)	Three Months Ended September 30,					
	Interest Income/ (Expense)	2013 Average Amortized Cost	Yield	Interest Income/ (Expense)	2012 Average Amortized Cost	Yield
<b>Interest Income</b>						
Residential loans	\$ 9,193	\$ 860,923	4.27%	\$ 4,378	\$ 466,246	3.76%
Commercial loans	10,740	415,632	10.34%	7,288	267,032	10.92%
Trading securities	7,798	203,805	15.30%	3,135	33,592	37.33%
Available-for-sale securities	21,851	967,864	9.03%	21,590	879,577	9.82%
Cash and cash equivalents	4	273,970	0.01%	15	66,818	0.09%
<b>Total interest income</b>	<b>49,586</b>	<b>2,722,194</b>	<b>7.29%</b>	<b>36,406</b>	<b>1,713,265</b>	<b>8.50%</b>
<b>Interest Expense</b>						
Short-term debt	(5,227)	1,150,917	(1.82)%	(2,737)	570,775	(1.92)%
ABS issued	(3,506)	273,999	(5.12)%	(1,177)	183,568	(2.56)%
Long-term debt <sup>(1)</sup>	(5,420)	450,296	(4.81)%	(968)	138,289	(2.80)%
Interest rate agreements <sup>(1)</sup>	(1,474)	138,335	(4.26)%	(1,409)	138,289	(4.08)%
<b>Total interest expense</b>	<b>(15,627)</b>	<b>1,875,212</b>	<b>(3.33)%</b>	<b>(6,291)</b>	<b>892,632</b>	<b>(2.82)%</b>
<b>Net Interest Income</b>	<b>33,959</b>			<b>30,115</b>		
Provision for loan losses	(843)			(506)		
Other MVA, net	538			(1,534)		
<b>Net Interest Income After Provision and Other MVA</b>	<b>\$ 33,654</b>			<b>\$ 28,075</b>		

(1) Interest rate agreements expense relates to cash-flow hedges on a portion of our long-term debt. The combined expense yield on our hedged long-term debt was 6.95% and 6.88% for the three months ended September 30, 2013 and 2012, respectively.



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(Dollars in Thousands)	Nine Months Ended September 30,					
	Interest Income/ (Expense)	2013 Average Amortized Cost	Yield	Interest Income/ (Expense)	2012 Average Amortized Cost	Yield
<b>Interest Income</b>						
Residential loans	\$ 26,809	\$ 913,560	3.91%	\$ 11,485	\$ 383,464	3.99%
Commercial loans	30,534	389,149	10.46%	17,782	212,169	11.17%
Trading securities	18,604	117,741	21.07%	8,767	34,176	34.20%
Available-for-sale securities	65,876	965,983	9.09%	64,959	847,191	10.22%
Cash and cash equivalents	153	150,004	0.14%	45	113,754	0.05%
<b>Total interest income</b>	<b>141,976</b>	<b>2,536,437</b>	<b>7.46%</b>	<b>103,038</b>	<b>1,590,754</b>	<b>8.64%</b>
<b>Interest Expense</b>						
Short-term debt	(13,721)	1,020,675	(1.79)%	(6,863)	469,350	(1.95)%
ABS issued	(10,793)	295,017	(4.88)%	(3,775)	197,554	(2.55)%
Long-term debt <sup>(1)</sup>	(12,500)	370,320	(4.50)%	(2,938)	138,277	(2.83)%
Interest rate agreements <sup>(1)</sup>	(4,408)	138,323	(4.25)%	(4,194)	138,277	(4.04)%
<b>Total interest expense</b>	<b>(41,422)</b>	<b>1,686,012</b>	<b>(3.28)%</b>	<b>(17,770)</b>	<b>805,180</b>	<b>(2.94)%</b>
<b>Net Interest Income</b>	<b>100,554</b>			<b>85,268</b>		
Provision for loan losses	(2,419)			(1,156)		
Other MVA, net	(5,692)			(3,500)		
<b>Net Interest Income After Provision and Other MVA</b>	<b>\$ 92,443</b>			<b>\$ 80,612</b>		

(1) Interest rate agreements expense relates to cash-flow hedges on a portion of our long-term debt. The combined expense yield on our hedged long-term debt was 6.85% and 6.87% for the nine months ended September 30, 2013 and 2012, respectively.

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Net interest income after provision and other MVA in the third quarter of 2013 increased \$6 million from the third quarter of 2012. The increase was primarily due to a \$13 million increase in interest income attributable to higher average earning assets and positive other MVA, net, which increased \$1 million from the third quarter of 2012. These increases were partially offset by a \$9 million increase in interest expense, as we funded our investments with a greater portion of debt in the third quarter of 2013 than in the prior year with a high average cost, primarily due to the convertible long-term debt issued in the first quarter of 2013.

Net interest income after provision and other MVA increased \$12 million during the nine months ended September 30, 2013 compared to the same period in 2012, primarily due to a \$39 million increase in interest income attributable to higher average earning assets. The increase in interest income was partially offset by a \$24 million increase in interest expense, as we funded our investments with a greater portion of debt in 2013 than in prior years, as well as a \$2 million increase in negative other MVA, net, and a \$1 million increase in provision for loan losses.

**Net Interest Income at Redwood (Parent)**

Interest income on AFS securities at Redwood was \$22 million for both the three months ended September 30, 2013 and 2012. Interest income on AFS securities at Redwood was \$66 million and \$65 million for the nine months ended September 30, 2013 and 2012, respectively. The following tables present the components of the interest income we earned on AFS securities for the three and nine months ended September 30, 2013 and 2012.

**Table 13 Interest Income AFS Securities at Redwood (Parent)**

Three Months Ended September 30, 2013	Yield as a Result of <sup>(1)</sup>						
	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income
(Dollars in Thousands)							
<b>Residential</b>							
Senior	\$ 4,523	\$ 5,208	\$ 9,731	\$ 428,080	4.23 %	4.87 %	9.09 %
Re-REMIC	2,709	865	3,574	101,808	10.64 %	3.40 %	14.04 %
Subordinate	5,834	2,712	8,546	437,976	5.33 %	2.48 %	7.80 %
<b>Total AFS Securities</b>	<b>\$ 13,066</b>	<b>\$ 8,785</b>	<b>\$ 21,851</b>	<b>\$ 967,864</b>	<b>5.40 %</b>	<b>3.63 %</b>	<b>9.03 %</b>

Three Months Ended September 30, 2012	Yield as a Result of <sup>(1)</sup>						
	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income
(Dollars in Thousands)							
<b>Residential</b>							
Senior	\$ 7,687	\$ 5,159	\$ 12,846	\$ 668,762	4.60 %	3.09 %	7.69 %
Re-REMIC	3,443	(161)	3,282	82,124	16.77 %	(0.78) %	15.99 %
Subordinate	2,662	2,157	4,819	124,644	8.54 %	6.92 %	15.46 %
<b>Total Residential</b>	<b>13,792</b>	<b>7,155</b>	<b>20,947</b>	<b>875,530</b>	<b>6.30 %</b>	<b>3.27 %</b>	<b>9.57 %</b>
Commercial	452	191	643	4,047	44.68 %	18.88 %	63.56 %

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CDO	29	(29)	-	-	-	-	-
<b>Total AFS Securities</b>	\$ 14,273	\$ 7,317	\$ 21,590	\$ 879,577	6.49 %	3.33 %	9.82 %

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Nine Months Ended September 30, 2013					Yield as a Result of <sup>(1)</sup>		
(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income
<b>Residential</b>							
Senior	\$ 18,249	\$ 14,656	\$ 32,905	\$ 537,486	4.53 %	3.64 %	8.16 %
Re-REMIC	8,234	2,932	11,166	100,808	10.89 %	3.88 %	14.77 %
Subordinate	14,136	7,044	21,180	327,436	5.76 %	2.87 %	8.62 %
<b>Total Residential</b>	40,619	24,632	65,251	965,730	5.61 %	3.40 %	9.01 %
Commercial	647	(22)	625	253	340.97 %	(11.59) %	329.38 %
<b>Total AFS Securities</b>	\$ 41,266	\$ 24,610	\$ 65,876	\$ 965,983	5.70 %	3.40 %	9.09 %

Nine Months Ended September 30, 2012					Yield as a Result of <sup>(1)</sup>		
(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income
<b>Residential</b>							
Senior	\$ 22,319	\$ 18,080	\$ 40,399	\$ 642,702	4.63 %	3.75 %	8.38 %
Re-REMIC	9,563	(273)	9,290	91,434	13.95 %	(0.40) %	13.55 %
Subordinate	7,796	5,746	13,542	109,063	9.53 %	7.02 %	16.55 %
<b>Total Residential</b>	39,678	23,553	63,231	843,199	6.27 %	3.72 %	9.99 %
Commercial	1,302	426	1,728	3,991	43.50 %	14.23 %	57.73 %
CDO	87	(87)	-	-	-	-	-
<b>Total AFS Securities</b>	\$ 41,067	\$ 23,892	\$ 64,959	\$ 847,190	6.46 %	3.76 %	10.22 %

(1) Cash flow from many of our subordinate securities can be volatile and in certain cases (e.g., when the fair values of certain securities are close to zero) any interest income earned can result in unusually high reported yields that are not sustainable and not necessarily meaningful.

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Interest income from AFS securities at Redwood for the third quarter of 2013 was unchanged from the third quarter of 2012 as the increase in average earning assets offset the decline from lower yields.

Interest income from trading securities at Redwood was \$8 million in the third quarter of 2013, as compared to \$3 million in the third quarter of 2012, an increase of \$5 million. The increase in interest income from trading securities during the third quarter of 2013 was primarily due to an increase in average balances of these securities, as new investments during the first nine months of 2013 outpaced sales and principal paydowns.

Over time, changes in the value of trading securities will be recorded as valuation changes in mortgage banking activities, net, or other market valuation adjustments, net. The yields on this portfolio will be affected by changes in market value and variations in cashflows caused by changing prepayments and benchmark interest rates.

Interest income from residential loans at Redwood was \$9 million in the third quarter of 2013, as compared to \$4 million in the third quarter of 2012, an increase of \$5 million. The increase in interest income from residential loans during the third quarter of 2013 was primarily due to an increase in average balances of these loans, as we continued to expand our Residential Mortgage Banking Activities during the first nine months of 2013.

Interest income from commercial loans at Redwood was \$11 million in the third quarter of 2013, as compared to \$7 million in the third quarter of 2012, an increase of \$4 million. The increase in interest income from commercial loans during the third quarter of 2013 was primarily due to an increase in average balances of these loans, as we continued to originate senior and mezzanine commercial loans during the first nine months of 2013.

***Interest Expense on Short-Term Debt***

At September 30, 2013, we had \$838 million of short-term debt outstanding. For both the three and nine months ended September 30, 2013, the highest balance of our short-term debt outstanding was \$1.45 billion. In the ordinary course of our business, we use short-term recourse debt through several different types of borrowing facilities and use cash borrowings under these facilities to, among other things, fund the acquisition of residential and commercial loans we acquire (including those we acquire in anticipation of securitization), finance investments in securities and other investments, and otherwise fund our business and operations.

The following table presents the spread between the yield on unsecuritized loans and securities and their specific debt financing costs at September 30, 2013.

**Table 14 Interest Expense Specific Borrowing Costs**

<b>September 30, 2013</b>	<b>Residential Loans</b>	<b>Residential Securities</b>
Asset yield	3.75%	7.12%
Short-term debt yield	1.74%	1.59%
<b>Net spread</b>	<b>2.01%</b>	<b>5.53%</b>

At September 30, 2013, we had five residential loan warehouse facilities with a total outstanding debt balance of \$462 million (secured by residential loans with an aggregate fair value of \$519 million) and a total borrowing limit of \$1.65 billion. We also had a \$100 million short-term commercial warehouse facility with a total outstanding balance of \$5

million. Each residential loan financed under one of our residential loan warehouse facilities can only be financed for a maximum number of days (generally less than 365 days), after which the financing expires and must be repaid. We generally intend to repay the short-term financing of a loan under one of those facilities at or prior to the expiration of that financing with the proceeds of a securitization or other sale of that loan, through the proceeds of other short-term borrowings, or with cash available from other equity or long-term debt capital sources.

In addition, at September 30, 2013, we had an aggregate outstanding short-term debt balance of \$371 million under seven securities repurchase facilities, which was secured by securities with a fair market value of \$500 million, resulting in a debt-to-equity leverage ratio for these residential securities of 2.9x (excluding the additional risk capital we hold related to these short-term borrowings). The financing for each security financed through one of our securities repurchase facilities is limited in its initial term to a maximum number of days (generally 90 days or less). We generally intend to repay the short-term financing of a security under one of these facilities through a renewal of that financing with the same counterparty, through a sale of the security, or with cash available from other equity or long-term debt capital sources. We also had a secured line of credit with no outstanding debt balance and a total borrowing limit of \$10 million (secured by securities with a fair market value in excess of \$10 million) at September 30, 2013.



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At December 31, 2012, we had four residential loan warehouse facilities with a total outstanding debt balance of \$180 million (secured by residential loans with an aggregate value in excess of the outstanding debt) and a total borrowing limit of \$800 million. In addition, at December 31, 2012, we had an aggregate outstanding short-term debt balance of \$372 million under seven securities repurchase facilities (secured by securities with a fair market value of approximately \$480 million). We also had one secured line of credit with no outstanding debt balance and a total borrowing limit of \$10 million (secured by securities with a fair market value in excess of \$10 million) at December 31, 2012.

For additional discussion of our short-term debt, including information regarding margin and financial covenants see *Risks Relating to Short-Term Debt Incurred Under Residential Mortgage Loan Warehouse Facilities, Securities Repurchase Facilities, and Other Short-Term Debt Facilities; and Risks Relating to Debt Incurred Under Commercial Debt Investment Repurchase Facilities* below in this Quarterly Report on Form 10-Q.

**Other MVA at Redwood (Parent)**

The following table shows the impact of other market valuation adjustments and impairments (including any relating to securities held at the Residential Resecuritization) on our consolidated statements of income for the three and nine months ended September 30, 2013 and 2012.

**Table 15 Other MVA at Redwood (Parent)**

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Residential loans, held-for-sale	\$ (11)	\$ 90	\$ 68	\$ 572
Trading securities	540	19	(4,168)	(983)
Impairments on AFS securities	-	(1,207)	(1,666)	(1,842)
Risk management derivatives	9	(436)	74	(1,247)
<b>Total Other MVA, Net</b>	<b>\$ 538</b>	<b>\$ (1,534)</b>	<b>\$ (5,692)</b>	<b>\$ (3,500)</b>

During the three months ended September 30, 2013, we recognized less than \$1 million of positive other market valuation adjustments, as compared to negative \$2 million for the three months ended September 30, 2012. The \$2 million increase is primarily due to an increase in value of certain of our fair value securities during the third quarter of 2013 and a decrease in impairment expense.

**Mortgage Banking Activities, Net**

Mortgage banking activities, net, includes certain results attributable to our residential and commercial loan business activities. This includes valuation changes related to loans and MSRs on our balance sheet at fair value, the valuation changes related to derivatives and IO securities used to manage certain risks associated with the residential and commercial loans we own or plan to acquire and securitize or sell to third parties, gains from mortgage loan sales, and net income from MSRs. See Table 4 in the Summary of Results of Operations section above for details of the components of mortgage banking activities, net.

*Valuation Changes on Residential Loans*

In the third quarter of 2013, we elected the fair value option for \$1.28 billion (principal balance) of residential loans we acquired. We anticipate electing the fair value option for future purchases of residential loans that we intend to sell to third parties or transfer to Sequoia securitizations. In the third quarter of 2013, net valuation losses on the fair value of residential loans primarily resulted from increases in mortgage interest rates as well as declines in the values of triple-A rated Sequoia RMBS.

*Valuation Changes on Commercial Loans*

In the third quarter of 2013, we elected the fair value option for \$113 million (principal balance) of commercial senior loans we acquired. We anticipate electing the fair value option for future purchases of commercial senior loans that we intend to sell to third parties.

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**Table of Contents***Mortgage Servicing Rights*

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

During the first nine months of 2013, we transferred an aggregate \$5.25 billion (principal balance) of residential loans to eleven Sequoia securitization entities and accounted for the transfers as sales in accordance with GAAP. As a result of these sales, during the nine months ended September 30, 2013, we recorded MSRs of \$41 million at a taxable REIT subsidiary of ours. During the nine months ended September 30, 2013, we recorded MSRs of \$1 million associated with \$72 million of loans sold to third parties. During the nine months ended September 30, 2013, we also purchased \$3 million of MSRs associated with a \$307 million pool of conforming loan principal balance. Conforming loans are mortgage loans that conform to Fannie Mae or Freddie Mac guidelines. At September 30, 2013, the principal balance of the loans associated with our MSRs was \$5.58 billion, as compared to \$1.02 billion at December 31, 2012. In the first nine months of 2013, we earned a net \$5 million from MSRs and at September 30, 2013, the fair value of MSRs was \$60 million. In the first nine months of 2012, we earned less than \$1 million from MSRs. The estimated fair value of our MSRs during the three months ended September 31, 2013 did not change from the end of the second quarter of 2013.

*Risk Management Derivatives Related to our Residential and Commercial Loan Business*

Net valuation gains from risk management derivatives related to our residential and commercial loans held for sale were less than \$1 million and \$51 million for the three and nine months ended September 30, 2013, respectively. As part of our ongoing risk management activities, we attempt to manage the risk of changes in the value of fixed-rate and hybrid loans awaiting sale or securitization that would result primarily from a change in benchmark interest rates. We are exposed to this risk between the time a mortgage interest rate is established for each loan we plan to acquire, through the time the loan is sold or securitized. Under normal market conditions and assuming we have managed this risk well, we would expect our risk management activities including the use of interest rate agreements and other derivatives to reduce our risk exposure to changing interest rates so that the gain or loss in the value of our derivatives would, to varying degrees, offset a loss or gain in the value of these loans, and ultimately the loss or gain of those loans at the time they are sold.

*Sequoia Interest-Only Securities*

During the three and nine months ended September 30, 2013, we recorded net negative market valuation adjustments of \$2 million and positive market value adjustments of \$36 million, respectively, on Sequoia IO securities. The increase in value during the nine months ended September 30, 2013, primarily resulted from a sharp rise in interest rates during the second quarter of 2013.

*Gains on Mortgage Loan Sales and Securitizations*

We elected the fair value option for held-for-sale residential loans purchased subsequent to June 30, 2012 and for held-for-sale commercial senior loans originated subsequent to March 31, 2013. Amounts reported as net gains on loan sales and securitizations for the first nine months of 2013 and 2012 relate to the sale of loans held at the lower of cost or fair value that were purchased or originated prior to the dates we began to elect the fair value option for these loans and represent the net benefit of the gross proceeds from the sale of the loans, less the carrying value of the loans and any related issuance costs.

During the first nine months of 2013, we recognized \$8 million of gains on the sale and origination of 12 held-for-sale commercial senior loans that we originated during the first quarter of 2013. We also recognized \$3 million of gains related to four table-funded loans originated by us (meaning a third party funded and purchased the loan at closing).

**Table of Contents***Impact of Mortgage Banking Activities, Net, on Redwood's Operations*

Excluded from mortgage banking activities, net, is the net interest income that we earn from the loans we acquire for future sale or securitization. The net income from these loans is included as part of the interest income at Redwood and the interest expense associated with the related borrowing costs from our warehouse facilities is included as part of the short-term interest expense at Redwood. Additionally, the interest we earn from investments we retain from Sequoia securitizations, including interest-only securities, and any associated short-term debt financing costs are included in net interest income.

**Earning Assets – Redwood (Parent)***Residential Loans at Redwood (Parent)*

During the third quarter of 2013, we continued to purchase newly originated residential loans held for sale to Sequoia securitization entities and third parties. We elected the fair value option for all of the residential loans we acquired during the third quarter of 2013 and anticipate electing the fair value option for all future purchases of residential loans that we intend to sell to third parties or to Sequoia securitization entities.

During the third quarter of 2013, we completed three residential prime jumbo securitizations for a total of \$1.21 billion. We also sold an additional \$602 million of residential loans to third parties, and recognized net market valuation losses of \$11 million during the three months ended September 30, 2013. At September 30, 2013, our pipeline of residential loans identified for purchase was \$595 million. Active sellers increased from 62 at December 31, 2012 to 112 at September 30, 2013.

At September 30, 2013, residential loans at Redwood had an outstanding carrying value of \$728 million, up from \$563 million at December 31, 2012. The \$728 million of prime residential loans, were comprised of \$472 million 30-year fixed rate loans, \$66 million 15-year and 20-year fixed rate loans, and \$190 million hybrid loans. The following table provides the activity of residential loans at Redwood during the three and nine months ended September 30, 2013.

**Table 16 Residential Loans at Redwood (Parent) – Activity**

(In Thousands)	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Fair Value Option	At Lower of Cost or Fair Value	Fair Value Option	At Lower of Cost or Fair Value
Balance at beginning of period	\$ 1,219,368	\$ 1,729	\$ 553,576	\$ 9,082
Acquisitions	1,294,372	-	6,448,724	(27)
Sales	(1,771,727)	-	(6,250,235)	(5,747)
Principal repayments	(4,188)	-	(7,590)	(1,653)
Changes in fair value, net	(11,664)	(11)	(18,314)	63
<b>Balance at End of Period</b>	<b>\$ 726,161</b>	<b>\$ 1,718</b>	<b>\$ 726,161</b>	<b>\$ 1,718</b>

The following table details outstanding principal balances for these loans by product type at September 30, 2013.

*Table 17 Characteristics of Residential Loans at Redwood (Parent)*

September 30, 2013

(Dollars In Thousands)	Principal Value	Weighted Average Coupon
<b>First Lien Prime</b>		
Fixed	\$ 536,387	4.00%
Hybrid	186,797	3.37%
ARM	1,512	1.78%
<b>Total Outstanding Principal</b>	<b>\$ 724,696</b>	<b>3.83%</b>

**Table of Contents****Commercial Loans at Redwood (Parent)**

At September 30, 2013, commercial loans at Redwood had an outstanding carrying value of \$380 million, up from \$313 million at December 31, 2012. We elected the fair value option for all of the senior commercial loans we originated during the third quarter of 2013 and anticipate electing the fair value option for all future senior commercial loans that we originate and intend to sell to third parties. The following table provides the activity of commercial loans held-for-sale at Redwood (Parent) during the three and nine months ended September 30, 2013.

**Table 18 Commercial Loans at Redwood (Parent) Activity**

(In Thousands)	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Held-for-Sale	Held-for- Investment	Held-for-Sale	Held-for- Investment
Balance at beginning of period	\$ 149,470	\$ 345,353	\$ 8,500	\$ 304,510
Originations/acquisitions	112,991	8,532	416,224	63,071
Sales	(238,102)	-	(399,865)	(230)
Principal repayments	(109)	(739)	(264)	(12,955)
Discount amortization	-	138	-	464
Provision for loan losses	-	(844)	-	(2,420)
Changes in fair value, net	3,163	-	2,818	-
<b>Balance at End of Period</b>	<b>\$ 27,413</b>	<b>\$ 352,440</b>	<b>\$ 27,413</b>	<b>\$ 352,440</b>

**Commercial Loans at Fair Value**

At September 30, 2013, there were four senior loans held-for-sale with a carrying value of \$27 million. During the third quarter of 2013, we originated and funded 12 senior commercial loans for \$113 million, as compared to 10 senior loans of \$150 million in the second quarter of 2013. During the first nine months of 2013, we originated 33 senior loans for \$416 million.

**Commercial Loans Held-for-Investment**

At September 30, 2013, there were 50 commercial mezzanine loans held-for-investment with an outstanding principal balance of \$362 million, an allowance for loan losses of \$7 million, and a carrying value of \$352 million. During the third quarter of 2013, we originated two mezzanine loans for \$9 million, as compared to six loans for \$19 million in the second quarter of 2013. During the first nine months of 2013, we originated 17 mezzanine loans for \$63 million. Our securitized mezzanine portfolio totaled \$269 million at September 30, 2013, down from \$284 million at December 31, 2012, primarily resulting from the prepayment of a \$12 million loan.

On average, our commercial held-for-investment loans have a maturity of more than five years, an unlevered yield in excess of 10% per annum before credit costs, a loan-to-value ratio of 73% at origination, and a debt service coverage ratio at origination of 1.30x based on our underwritten cash flows. The following table details principal balances and other characteristics for these loans by product type at September 30, 2013.

**Table 19 Commercial Loans Characteristics of Loans Held-for-Investment at Redwood (Parent)**

<b>September 30, 2013 (Dollars In Thousands)</b>	<b>Number of Loans</b>	<b>Average Loan Size</b>	<b>Principal Balance</b>	<b>Percent of Total Principal</b>	<b>Weighted Average DSCR</b>	<b>Weighted Average LTV</b>
Multi-family	22	\$ 5,481	\$ 120,582	33%	1.26	79%
Office	8	9,862	78,893	22%	1.35	72%
Hospitality	9	9,244	83,195	23%	1.38	62%
Retail	5	10,098	50,489	14%	1.16	76%
Self-storage	4	6,000	24,000	7%	1.34	77%
Industrial	2	2,300	4,600	1%	1.37	70%
<b>Total</b>	<b>50</b>	<b>\$ 7,235</b>	<b>\$ 361,759</b>	<b>100%</b>	<b>1.30</b>	<b>73%</b>



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The following table details principal balances for these loans by geographic concentration at September 30, 2013.

***Table 20 Geographic Concentration of Commercial Loans Held-for-Investment at Redwood (Parent)***

<b>Geographic Concentration (by Principal)</b>	<b>September 30, 2013</b>
New York	21%
California	20%
Florida	10%
Michigan	7%
Texas	6%
Illinois	6%
Tennessee	4%
North Carolina	3%
Other states (none greater than 3%)	23%
<b>Total</b>	<b>100%</b>

***Derivative Financial Instruments at Redwood (Parent)***

*Risks Management Derivatives*

In order to manage certain risks associated with residential and commercial loans we own or plan to acquire or originate, at September 30, 2013, we were party to interest rate agreements, TBA contracts sold, and financial futures. Net market valuation adjustments on risk management derivatives related to our loan pipeline were positive less than \$1 million and negative \$3 million for the three months ended September 30, 2013 and 2012, respectively. Net market valuation adjustments on risk management derivatives related to our loan pipeline were positive \$51 million and negative \$9 million for the nine months ended September 30, 2013 and 2012, respectively.

*Derivatives Designated as Cash Flow Hedges*

To hedge the variability in interest expense related to certain long-term debt, we entered into interest rate swaps during 2010 with an aggregate notional balance of \$140 million at September 30, 2013. We designated these derivatives as cash flow hedges. For the nine months ended September 30, 2013 and 2012, these cash flow hedges increased in value by \$25 million and decreased in value by \$1 million, respectively, which was recorded to accumulated other comprehensive income, a component of equity. At September 30, 2013, interest rate agreements currently accounted for as cash flow hedges had an unrealized loss of \$23 million.

While changes in the value of derivatives designated as cash flow hedges affect reported book value from quarter to quarter, the derivatives hedging certain long-term debt closely match the terms of the debt, which has a remaining life of approximately 25 years.

***Securities at Redwood (Parent)***

We classify most senior, re-REMIC, and subordinate securities as AFS securities. Of the senior securities owned at Redwood at September 30, 2013, \$141 million of prime securities and \$135 million of non-prime securities were financed through the Residential Resecuritization. Re-REMIC securities, as presented herein, were created by third

parties through the resecuritization of certain senior interests to provide additional credit support to those interests. The commercial securities that we owned were subordinate securities.

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During the three and nine months ended September 30, 2013, we acquired \$80 million and \$379 million of investments from Sequoia securitizations we sponsored, respectively. The following table provides real estate securities activity at Redwood for the three and nine months ended September 30, 2013.

**Table 21 Real Estate Securities Activity at Redwood (Parent)****Three Months Ended September 30, 2013**

(In Thousands)	Senior	Residential Re-REMIC	Subordinate	Commercial	Total
Beginning fair value	\$ 775,962	\$ 154,167	\$ 384,176	\$ -	\$ 1,314,305
Acquisitions					
Sequoia securities	12,105	-	68,123	-	80,228
Third-party securities	100,539	-	42,090	-	142,629
Sales					
Sequoia securities	(13,943)	-	-	-	(13,943)
Third-party securities	(163,986)	-	(4,106)	-	(168,092)
Gains on sales and calls, net	8,397	-	1,921	-	10,318
Effect of principal payments <sup>(1)</sup>	(32,128)	-	(5,497)	-	(37,625)
Change in fair value, net	(1,663)	2,179	(3,658)	-	(3,142)
<b>Ending Fair Value</b>	<b>\$ 685,283</b>	<b>\$ 156,346</b>	<b>\$ 483,049</b>	<b>\$ -</b>	<b>\$ 1,324,678</b>

**Nine Months Ended September 30, 2013**

(In Thousands)	Senior	Residential Re-REMIC	Subordinate	Commercial	Total
Beginning fair value	\$ 744,332	\$ 163,035	\$ 187,317	\$ 14,069	\$ 1,108,753
Acquisitions					
Sequoia securities	103,955	-	275,219	-	379,174
Third-party securities	100,539	-	42,090	-	142,629
Sales					
Sequoia securities	(30,877)	-	-	-	(30,877)
Third-party securities	(163,986)	-	(4,298)	(14,069)	(182,353)
Gains on sales and calls, net	8,397	-	2,447	12,038	22,882
Effect of principal payments <sup>(1)</sup>	(96,494)	-	(14,461)	-	(110,955)
Change in fair value, net	19,417	(6,689)	(5,265)	(12,038) <sup>(2)</sup>	(4,575)
<b>Ending Fair Value</b>	<b>\$ 685,283</b>	<b>\$ 156,346</b>	<b>\$ 483,049</b>	<b>\$ -</b>	<b>\$ 1,324,678</b>

(1)

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

- (2) The change in fair value, net reflects the liquidation of our remaining commercial securities, resulting in an ending fair value of zero for this portfolio.

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The amortized cost of our available-for-sale securities, which accounts for all but \$131 million of our \$1.3 billion securities portfolio, was 71% of face value and the fair value was 81% of face value at September 30, 2013. The following tables present the carrying value (which equals fair value) as a percent of principal balance for securities owned at Redwood at September 30, 2013 and December 31, 2012.

*Table 22 Fair Value as Percent of Principal Balance for Real Estate Securities at Redwood (Parent) <sup>(1)</sup>*

<b>September 30, 2013</b>										
<b>(Dollars in Millions)</b>										
	<b>2004 &amp; Earlier</b>		<b>2005</b>		<b>2006 - 2008</b>		<b>2012 - 2013 <sup>(2)</sup></b>		<b>Total</b>	
	<b>Value</b>	<b>%</b>	<b>Value</b>	<b>%</b>	<b>Value</b>	<b>%</b>	<b>Value</b>	<b>%</b>	<b>Value</b>	<b>%</b>
<b>Residential Senior</b>										
Prime	\$ 5	97%	\$ 264	96%	\$ 92	97%	\$ 120	N/A	\$ 481	96%
Non-prime	84	93%	115	82%	5	93%	-	-	204	86%
<b>Total</b>	<b>89</b>	<b>93%</b>	<b>379</b>	<b>91%</b>	<b>97</b>	<b>96%</b>	<b>120</b>	<b>N/A</b>	<b>685</b>	<b>92%</b>
<b>Residential Re-REMIC</b>										
	-	-	64	73%	93	73%	-	-	156	73%
<b>Residential Subordinate</b>										
Prime	43	53%	14	62%	1	12%	425	77%	483	73%
Non-prime	-	-	-	-	-	-	-	-	-	-
<b>Total</b>	<b>43</b>	<b>53%</b>	<b>14</b>	<b>62%</b>	<b>1</b>	<b>12%</b>	<b>425</b>	<b>77%</b>	<b>483</b>	<b>73%</b>
<b>Total Securities at Redwood</b>	\$ 132		\$ 457		\$ 191		\$ 545		\$ 1,325	
<b>December 31, 2012</b>										
<b>(Dollars in Millions)</b>										
	<b>2004 &amp; Earlier</b>		<b>2005</b>		<b>2006 - 2008</b>		<b>2012 <sup>(2)</sup></b>		<b>Total</b>	
	<b>Value</b>	<b>%</b>	<b>Value</b>	<b>%</b>	<b>Value</b>	<b>%</b>	<b>Value</b>	<b>%</b>	<b>Value</b>	<b>%</b>
<b>Residential Senior</b>										
Prime	\$ 22	100%	\$ 190	93%	\$ 255	99%	\$ 10	N/A	\$ 477	96%
Non-prime	99	95%	162	84%	6	93%	-	-	267	88%
<b>Total</b>	<b>121</b>	<b>96%</b>	<b>352</b>	<b>89%</b>	<b>261</b>	<b>99%</b>	<b>10</b>	<b>N/A</b>	<b>744</b>	<b>93%</b>
<b>Residential Re-REMIC</b>										
	-	-	67	76%	96	75%	-	-	163	76%
<b>Residential Subordinate</b>										
Prime	56	51%	13	54%	2	14%	114	81%	185	64%
Non-prime	2	38%	1	9%	-	-	-	-	3	11%
<b>Total</b>	<b>58</b>	<b>50%</b>	<b>14</b>	<b>48%</b>	<b>2</b>	<b>14%</b>	<b>114</b>	<b>81%</b>	<b>188</b>	<b>60%</b>
<b>Commercial</b>	<b>14</b>	<b>72%</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>14</b>	<b>72%</b>
<b>Total Securities at Redwood</b>	<b>\$ 193</b>		<b>\$ 433</b>		<b>\$ 359</b>		<b>\$ 124</b>		<b>\$ 1,109</b>	

(1) Table may not foot due to rounding.

(2) Prime senior residential securities originated in 2012 and 2013 include interest-only securities. As these securities do not have a principal balance, the percentage of principal balance is not applicable.

***Residential Securities***

At September 30, 2013, the residential securities held at Redwood (as a percentage of current market value) consisted of fixed-rate assets (52%), adjustable-rate assets (21%), hybrid assets that reset within the next year (19%), and hybrid assets that reset between 12 and 36 months (8%).

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At September 30, 2013, credit reserves for our securities portfolio totaled \$136 million, or 9.2% of the principal balance of our residential securities, down from 14.6% at December 31, 2012. This decrease primarily resulted from a transfer of credit reserves to accretable unamortized discount, based on sustained improvements in the credit performance of loans underlying our securities that reduced our estimate of future losses on these loans. The increase in accretable unamortized discount will be recognized into income prospectively over the remaining life of the associated loans. During the three and nine months ended September 30, 2013, realized credit losses on our residential securities at Redwood totaled \$5 million and \$17 million, respectively. The following tables present the components of carrying value at September 30, 2013 and December 31, 2012 for our residential securities.

**Table 23 Carrying Value of Residential Securities at Redwood (Parent)**

<b>September 30, 2013</b> <b>(In Thousands)</b>	<b>Senior</b>				
	<b>Prime</b>	<b>Non-prime</b>	<b>Re-REMIC</b>	<b>Subordinate</b>	<b>Total</b>
Principal balance of AFS securities	\$ 379,598	\$ 225,649	\$ 214,660	\$ 661,291	\$ 1,481,198
Credit reserve	(12,964)	(12,813)	(33,621)	(76,894)	(136,292)
Net unamortized discount	(47,000)	(40,243)	(78,789)	(122,806)	(288,838)
Amortized cost	319,634	172,593	102,250	461,591	1,056,068
Gross unrealized gains	44,850	23,146	54,096	33,880	155,972
Gross unrealized losses	(662)	(585)	-	(16,969)	(18,216)
Carrying value of AFS securities	363,822	195,154	156,346	478,502	1,193,824
Carrying value of trading securities	117,443	8,864	-	4,547	130,854
<b>Total Carrying Value of Residential Securities</b>	<b>\$ 481,265</b>	<b>\$ 204,018</b>	<b>\$ 156,346</b>	<b>\$ 483,049</b>	<b>\$ 1,324,678</b>

<b>December 31, 2012</b> <b>(In Thousands)</b>	<b>Senior</b>				
	<b>Prime</b>	<b>Non-prime</b>	<b>Re-REMIC</b>	<b>Subordinate</b>	<b>Total</b>
Principal balance of AFS securities	\$ 485,033	\$ 278,229	\$ 215,863	\$ 298,276	\$ 1,277,401
Credit reserve	(26,100)	(18,104)	(47,235)	(95,593)	(187,032)
Net unamortized discount	(53,601)	(42,842)	(69,310)	(37,668)	(203,421)
Amortized cost	405,332	217,283	99,318	165,015	886,948
Gross unrealized gains	61,265	28,669	63,717	23,278	176,929
Gross unrealized losses	(74)	(686)	-	(1,605)	(2,365)
Carrying value of AFS securities	466,523	245,266	163,035	186,688	1,061,512
Carrying value of trading securities	10,409	22,134	-	629	33,172

<b>Total Carrying Value of Residential Securities</b>	\$ 476,932	\$ 267,400	\$ 163,035	\$ 187,317	\$ 1,094,684
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### *Senior Securities*

The fair value of our senior AFS securities was equal to 92% of their principal balance at September 30, 2013, while our amortized cost was equal to 81% of the principal balance. The fair value of our senior securities accounted for as trading securities was \$126 million. Volatility in income recognition for these securities is generally due to changes in prepayment rates and, to varying degrees, credit performance and interest rates.

The loans underlying all of our residential senior securities totaled \$13 billion at September 30, 2013, consisting of \$9 billion prime and \$4 billion of non-prime loans. These loans are located nationwide with a large concentration in California (45%). Serious delinquencies (90+ days, in foreclosure or REO) at September 30, 2013 were 9.51% of current balances. Serious delinquencies were 8.55% of current balances for loans in prime pools and 11.82% of current balances for loans in non-prime pools.

### *Re-REMIC Securities*

Our re-REMIC portfolio consists primarily of prime residential senior securities that were pooled and re-securitized in 2009 and 2010 by third parties to create two-tranche structures; we own support (or subordinate) securities within those structures. There were \$1.2 million of credit losses in our re-REMIC portfolio during the first nine months of 2013. We anticipate losses, including those that were part of our acquisition assumptions, and have provided for \$33 million of credit reserves on the \$215 million principal balance of those securities.

The fair value of our re-REMIC AFS securities was equal to 73% of the principal balance of the portfolio at September 30, 2013, while our amortized cost was equal to 48% of the principal balance. The loans underlying all of our residential re-REMIC securities



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totaled \$4 billion at September 30, 2013, and consisted of \$4 billion of prime loans and \$101 million non-prime credit quality collateral at time of origination. These loans are located nationwide with a large concentration in California (45%). Serious delinquencies (90+ days, in foreclosure or REO) at September 30, 2013 were 9.50% of current balances.

*Subordinate Securities*

The fair value of our subordinate AFS securities was equal to 72% of the principal balance at September 30, 2013, while our amortized cost was equal to 70% of the principal balance. Credit losses totaled \$15 million in our residential subordinate portfolio during the first nine months of 2013, as compared to \$37 million of losses during first nine months of 2012. We expect future losses will extinguish a portion of the outstanding principal of these securities, as reflected by the \$77 million of credit reserves we have provided for on the \$661 million principal balance of those securities.

The loans underlying all of our residential subordinate securities totaled \$17 billion at September 30, 2013, consisting of \$16 billion of prime loans and \$300 million of non-prime loans (at origination). These loans are located nationwide with a large concentration in California (41%). Loans 90+ days past due, in foreclosure or REO at September 30, 2013 were 3.29% of current balances. Serious delinquencies were 3.21% of current balances for loans in prime pools and 7.6% of current balances for loans in non-prime pools.

*Commercial Securities*

We sold all of our commercial securities during the first quarter of 2013, resulting in realized gains of \$12 million. At December 31, 2012, our commercial securities totaled \$14 million.

*Results of Operations Consolidated Entities*

The following table presents the net interest income after provision and other MVA at certain entities we were required to consolidate for financial reporting purposes under GAAP for the three and nine months ended September 30, 2013 and 2012. These consolidated entities include certain Sequoia entities and, for periods prior to the first quarter of 2013 presented herein, Acacia entities.

**Table 24 Net Interest Income After Provision and Other MVA at Consolidated Entities**

(Dollars in Thousands)	Three Months Ended September 30,					
	2013			2012		
	Interest Income/ (Expense)	Average Amortized Cost	Yield	Interest Income/ (Expense)	Average Amortized Cost	Yield
<b>Interest Income</b>						
Residential loans	\$ 7,834	\$ 1,910,814	1.64 %	\$ 16,040	\$ 3,128,076	2.05 %
Commercial loans	-	-	-	194	12,159	6.38 %
Trading securities	-	-	-	7,080	258,732	10.95 %
Cash and cash equivalents	-	687	-	3	19,714	0.04 %
<b>Total interest income</b>	<b>7,834</b>	<b>1,911,501</b>	<b>1.64 %</b>	<b>23,317</b>	<b>3,418,681</b>	<b>2.73 %</b>

<b>Interest Expense</b>						
ABS issued - Sequoia	(6,144)	1,835,401	(1.34)%	(10,970)	3,039,273	(1.44) %
ABS issued - Acacia	-	-	-	(8,695)	235,789	(14.75) %
Interest rate agreements - Sequoia	(62)	1,668,798	(0.01)%	(1,286)	2,607,882	(0.20) %
Interest rate agreements - Acacia	-	-	-	(1,043)	235,789	(1.77) %
<b>Total interest expense</b>	(6,206)	1,835,401	(1.35)%	(21,994)	2,843,671	(3.09) %
<b>Net Interest Income</b>						
	1,628			1,323		
Provision for loan losses	(884)			(813)		
Other MVA, net	(76)			2,491		
<b>Net Interest Income After Provision and Other MVA</b>	\$ 668			\$ 3,001		

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(Dollars in Thousands)	Nine Months Ended September 30,					
	Interest Income/ (Expense)	2013 Average Amortized Cost	Yield	Interest Income/ (Expense)	2012 Average Amortized Cost	Yield
<b>Interest Income</b>						
Residential loans	\$ 26,688	\$ 2,043,007	1.74 %	\$ 53,556	\$ 3,327,036	2.15 %
Commercial loans	-	-	-	581	12,130	6.39 %
Trading securities	-	-	-	20,806	250,154	11.09 %
Cash and cash equivalents	-	572	-	7	17,027	0.05 %
<b>Total interest income</b>	26,688	2,043,579	1.74 %	74,950	3,606,347	2.77 %
<b>Interest Expense</b>						
ABS issued - Sequoia	(20,012)	1,965,564	(1.36)%	(37,293)	3,235,915	(1.54)%
ABS issued - Acacia	-	-	-	(26,086)	225,286	(15.44)%
Interest rate agreements - Sequoia	(217)	1,752,960	(0.02)%	(3,414)	2,736,438	(0.17)%
Interest rate agreements - Acacia	-	-	-	(3,259)	225,286	(1.93)%
<b>Total interest expense</b>	(20,229)	1,965,564	(1.37)%	(70,052)	2,961,724	(3.15)%
<b>Net Interest Income</b>	6,459			4,898		
Reversal of provision for loan losses	1,926			902		
Other MVA, net	(407)			3,098		
<b>Net Interest Income After Provision and Other MVA</b>	\$ 7,978			\$ 8,898		

**Net Interest Income at Consolidated Entities**

Net interest income at consolidated entities will vary from period to period and depend primarily on changes in the levels of delinquencies and loss severities for loans held-for-investment, and changes in the rates of principal repayments or the investments held at these entities.

Net interest income at consolidated entities was \$2 million in the third quarter of 2013, as compared to \$1 million in the third quarter of 2012. Net interest income at consolidated entities was \$6 million in the first nine months of 2013, an increase of \$2 million from the first nine months of 2012. In the fourth quarter of 2012, we sold our economic interests in and subsequently deconsolidated all of our Acacia entities and 15 legacy Sequoia entities. The increase in net interest income was a result of the benefit of deconsolidating these securitizations, which in the aggregate had negative net interest income during 2012. We have not added to our consolidated entities balances since 2011.

**Other MVA at Consolidated Entities**

The following table shows the impact of other MVA and impairments at our consolidated entities for the three and nine months ended September 30, 2013 and 2012.

*Table 25 Other MVA at Consolidated Entities*

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Commercial loans, at fair value	\$ -	\$ 11	\$ -	\$ 134
Trading securities	-	35,080	-	85,905
Risk management derivatives	-	(4,214)	-	(9,384)
ABS issued - Acacia	-	(28,166)	-	(73,193)
REO	(76)	(220)	(407)	(364)
<b>Total Other MVA, Net</b>	<b>\$ (76)</b>	<b>\$ 2,491</b>	<b>\$ (407)</b>	<b>\$ 3,098</b>

For the three months ended September 30, 2013, there were less than \$1 million of net negative market valuation adjustments on REO properties at the legacy Sequoia entities. For the three months ended September 30, 2012, there were \$3 million of net positive

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market valuation adjustments on the assets and liabilities at the Acacia entities, and less than \$1 million of net negative market valuation adjustments on REO properties at the legacy Sequoia entities. For the nine months ended September 30, 2013, there were less than \$1 million of net negative market valuation adjustments on REO properties at the legacy Sequoia entities. For the nine months ended September 30, 2012, there were \$3 million of net positive market valuation adjustments on the assets and liabilities at the Acacia entities, and less than \$1 million of net negative market valuation adjustments on REO properties at the legacy Sequoia entities. Prior to the first quarter of 2013, we applied the fair value option provided under GAAP to account for the assets (e.g., loans and securities) and liabilities (e.g., ABS issued) at the consolidated Acacia entities. This option required that changes in the fair value of these assets and liabilities be recorded in the consolidated statements of income each reporting period. As we deconsolidated all Acacia entities in the fourth quarter of 2012, there will not be market valuation adjustments related to these items going forward.

***Loan Loss Provision at Consolidated Sequoia Entities***

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

The provision for loan losses at legacy consolidated Sequoia entities was \$1 million for both the three months ended September 30, 2013 and 2012. Net charge-offs were \$1 million (or 0.04% of outstanding loan balances) for the three months ended September 30, 2013, as compared to \$3 million (or 0.08% of outstanding loan balances) for the three months ended September 30, 2012. Charge-offs were generated by \$3 million and \$7 million of defaulted loan principal during the three months ended September 30, 2013 and 2012, respectively, for average implied loss severities of 31% and 37%, respectively.

The allowance for loan losses decreased to \$23 million (or 1.24% of outstanding residential loans held-for-investment balances) at September 30, 2013, from \$29 million (or 1.25% of outstanding residential loans held-for-investment balances) at December 31, 2012, primarily resulting from a reduction in outstanding loans balances as well as a decrease in observed loss severities. Serious delinquencies on loans held at consolidated Sequoia entities (90+ days delinquent) were \$69 million (or 3.70% of outstanding loan balances) at September 30, 2013, as compared to \$63 million (or 2.75% of outstanding loan balances) at December 31, 2012. We believe the increase in reported delinquencies during the quarter can be attributed to servicer changes that occurred during the quarter for a large portion of our consolidated portfolio and are not necessarily an indication of overall credit performance. Loans originated in Florida, California, New Jersey, New York, Connecticut, and Nevada accounted for 50% of total loans held by Sequoia entities and made up 52% of the serious delinquent loan balance at September 30, 2013.

At September 30, 2013, we estimate that there was one Sequoia entity that we consolidated for which the carrying value of the entity's liabilities exceeded the corresponding carrying value of the entity's assets. This is primarily attributable to the continued building of loan loss allowances for loans owned at this entity, resulting in lower asset carrying values. The estimated net negative assets (or equity) at this consolidated entity were less than \$1 million at September 30, 2013, an amount we expect to reverse through positive adjustments to earnings in future periods as the entity pays down or the entity is deconsolidated for financial reporting purposes.

**Table of Contents****Earning Assets Consolidated Entities****Real Estate Loans at Sequoia Entities**

The following table provides details of residential loan activity at consolidated Sequoia securitization entities for the three and nine months ended September 30, 2013.

**Table 26 Residential Loans at Sequoia Entities Activity**

<b>(In Thousands)</b>	<b>Three Months Ended September 30, 2013</b>	<b>Nine Months Ended September 30, 2013</b>
Balance at beginning of period	\$ 1,998,178	\$ 2,272,812
Principal repayments	(130,766)	(402,920)
Charge-offs, net	818	3,363
Premium amortization	(1,642)	(5,105)
Transfers to REO	(1,052)	(5,424)
(Provision for) reversal of provision for loan losses	(883)	1,927
<b>Balance at End of Period</b>	<b>\$ 1,864,653</b>	<b>\$ 1,864,653</b>

**Loan Characteristics**

The following table highlights unpaid principal balances for loans at consolidated Sequoia entities by product type at September 30, 2013. First lien adjustable rate mortgage (ARM) and hybrid loans comprise 90% of the consolidated Sequoia loan portfolio and were primarily originated in 2005 or prior. Conversely, fixed-rate loans, which make up 9% of the portfolio, were primarily originated in 2009 or later. Of the \$70 million of hybrid loans held at Sequoia securitization entities at September 30, 2013, \$36 million (or 51%) had reset as of September 30, 2013, and now act as ARM loans.

**Table 27 Loan Characteristics at Sequoia Entities**

<b>September 30, 2013 (Dollars In Thousands)</b>	<b>Principal Balance</b>	<b>Percent of Total</b>
First Lien		
ARM	\$ 1,614,423	86.35%
Fixed	164,882	8.82%
Hybrid (years to reset)		
Reset	35,598	1.90%
0-4	17,412	0.93%
5-8	16,349	0.87%
Second Lien		
ARM	21,062	1.13%

<b>Total Outstanding Principal</b>	\$	1,869,726	100.00%
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For outstanding loans at Sequoia entities consolidated by us at September 30, 2013, the weighted average FICO score (at origination) of borrowers backing these loans was 733 and the weighted average original LTV ratio of Sequoia loans was 66%.

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The following chart presents the weighted average prepayment speeds of loans held at consolidated Sequoia securitization entities still held at September 30, 2013, over the past four years.

The majority of hybrid loans and all of the fixed-rate loans at the consolidated Sequoia entities were securitized since 2010. Prepayment speeds on our hybrid and fixed rate loans declined during the third quarter of 2013 reflecting mortgage rates that began to rise in the second quarter of 2013. At September 30, 2013, hybrid loans at consolidated Sequoia entities had a weighted average coupon of 3.60%, and fixed-rate loans had a weighted average coupon of 4.65%. Prepayment speeds on our ARM loan population increased during the third quarter of 2013 as borrowers looked to lock in historically low interest rates through refinancing of their existing homes in anticipation of continued increases in mortgage rates. At September 30, 2013, LIBOR ARM loans at consolidated Sequoia entities had a weighted average coupon of 1.70%.

***Loan Repurchase Risk***

Subsidiaries of Redwood have purchased residential mortgage loans and either deposited those loans into Sequoia securitization trusts sponsored by RWT Holdings, Inc., a Redwood subsidiary, or sold those loans to third parties. The Sequoia trusts have subsequently issued residential mortgage backed securities; some of these Sequoia securitization trusts are not currently consolidated on our balance sheet for financial reporting purposes. In connection with these securitizations and loan sales, these subsidiaries of Redwood made certain representations and warranties related to these loans that could result in an obligation to repurchase these loans to the extent a violation of these representations and warranties occurred. We do not originate residential loans and believe that risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the third-party entity from whom we acquired the loans. However, in some cases, where loans were acquired from entities that have since become insolvent, repurchase claims would not be a contingency to a third party and may result in repurchase claims made against us. As of September 30, 2013, there have been no loan-level repurchase claims made to Redwood by Sequoia investors or third-party loan purchasers where the entity that originated the loans in question was insolvent. As a result, while it is possible that we may receive repurchase claims related to these securitizations in the future, we cannot make a reasonable estimate of potential future liabilities based on historical experience to date.

We do not currently maintain a loan repurchase reserve and management is not aware of any outstanding repurchase claims against Redwood that would require the establishment of such a reserve. In circumstances where we believe that there is a risk of loss due to a specific loan repurchase demand (i.e., due to an allegation of a breach of representations and warranties), we will review the need for any loan repurchase reserve in accordance with FASB guidance on accounting for contingencies and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated.

In addition, with respect to residential mortgage-backed securities issued by Sequoia securitization trusts prior to 2008, we believe that investors seeking recovery for any losses they incur on investments in these securities may be more likely to pursue remedies through securities-related litigation rather than through specific loan repurchase claims. We separately evaluate our exposure to such litigation when assessing whether the establishment of a litigation reserve is necessary under GAAP. For further discussion on litigation related contingencies see Note 14 to the financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.





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**Table of Contents****Capital Resources and Liquidity**

Set forth below is a discussion of our long-term debt and contractual obligations and commitments, as well as a discussion of asset-backed securities issued. For additional discussion of our capital resources and liquidity see *Summary of Financial Condition, Capital Resources, and Liquidity* above.

***Long-Term Debt at Redwood******Commercial Borrowings***

At September 30, 2013, we had one commercial loan warehouse facility with an outstanding balance of \$45 million and a total borrowing limit of \$150 million.

***Convertible Notes***

In March 2013, we issued \$287.5 million principal amount of 4.625% convertible senior notes due 2018. After deducting the underwriting discount and issuance costs, we received approximately \$279 million of net proceeds. Including amortization of deferred issuance costs, the interest expense yield on our convertibles notes was 5.53% and 5.49% for the three and nine months ended September 30, 2013, respectively. At September 30, 2013, the accrued interest payable balance on this debt was \$8 million.

***Other Long-term Debt***

Other long-term debt consists of \$100 million and \$50 million of trust preferred securities and subordinated notes, respectively issued by us in 2006 and 2007. This debt requires quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole. Beginning in the first quarter of 2011, we entered into interest rate swaps with aggregate notional values currently totaling \$140 million to hedge the variability in this long-term debt interest expense, fixing our gross interest expense yield at 6.75%. These swaps are accounted for as cash flow hedges with all interest income recorded as a component of net interest income and other valuation changes recorded as a component of equity.

***Asset-Backed Securities Issued at Securitization Entities***

At September 30, 2013, there were \$1.87 billion of loans owned at Sequoia securitization entities, which were funded with \$1.79 billion of ABS issued at Sequoia entities. At September 30, 2013, there were \$276 million of securities owned at the Residential Resecuritization, which were funded with \$112 million of ABS issued. At September 30, 2013, there were \$271 million (carrying value) of commercial loans owned at the Commercial Securitization, which were funded with \$159 million of ABS issued. The ABS issued are reported at their unpaid principal balances net of any unamortized premium or discount. During the fourth quarter of 2012, we sold our remaining interests in the Acacia entities and derecognized the associated assets and liabilities.

The following table provides detail on the activity for asset-backed securities issued by the Sequoia, Residential Resecuritization, and Commercial Securitization entities we consolidate for financial reporting purposes for the three and nine months ended September 30, 2013.

***Table 28 ABS Issued Activity    Securitization Entities*****Three Months Ended September 30, 2013**

<b>(In Thousands)</b>	<b>Consolidated Sequoia Entities</b>	<b>Residential Resecuritization</b>	<b>Commercial Securitization</b>	<b>Total</b>
Carrying value at beginning of period	\$ 1,920,614	\$ 134,156	\$ 159,526	\$ 2,214,296
Paydowns	(129,434)	(21,977)	(727)	(152,138)
Extinguishment of debt	(152)	-	-	(152)
Amortization	(341)	-	-	(341)
<b>Carrying Value at End of Period</b>	<b>\$ 1,790,687</b>	<b>\$ 112,179</b>	<b>\$ 158,799</b>	<b>\$ 2,061,665</b>

**Table of Contents****Nine Months Ended September 30, 2013**

(In Thousands)	Consolidated Sequoia Entities	Residential Resecuritization	Commercial Securitization	Total
Carrying value at beginning of period	\$ 2,193,481	\$ 164,746	\$ 171,714	\$ 2,529,941
Paydowns	(400,504)	(52,567)	(12,915)	(465,986)
Extinguishment of debt	(200)	-	-	(200)
Amortization	(2,090)	-	-	(2,090)
<b>Carrying Value at End of Period</b>	<b>\$ 1,790,687</b>	<b>\$ 112,179</b>	<b>\$ 158,799</b>	<b>\$ 2,061,665</b>

The following table presents our contractual obligations and commitments at September 30, 2013, as well as the obligations of the securitization entities that we sponsor and consolidate for financial reporting purposes.

**Table 29 Contractual Obligations and Commitments**

September 30, 2013 (In Millions)	Payments Due or Commitment Expiration by Period				Total
	Less Than 1 Year	1 to 3 Years	3 to 5 Years	After 5 Years	
<b>Obligations of Redwood</b>					
Short-term debt	\$ 838	\$ -	\$ -	\$ -	\$ 838
Convertible notes	-	-	288	-	288
Anticipated interest payments on convertible notes	13	27	27	-	67
Commercial borrowings	-	45	-	-	45
Anticipated interest payments on commercial borrowings	2	2	-	-	4
Other long-term debt	-	-	-	140	140
Anticipated interest payments on other long-term debt	4	8	10	140	162
Accrued interest payable	9	-	-	-	9
Operating leases	2	5	4	1	12
<b>Total Redwood Obligations and Commitments</b>	<b>\$ 868</b>	<b>\$ 87</b>	<b>\$ 329</b>	<b>\$ 281</b>	<b>\$ 1,565</b>

**Obligations of Consolidated Entities for Financial Reporting Purposes**

Consolidated ABS <sup>(1)</sup>	\$ -	\$ 32	\$ -	\$ 2,030	\$ 2,062
Anticipated interest payments on ABS <sup>(2)</sup>	33	132	185	397	747
Accrued interest payable	2	-	-	-	2

Total Obligations of Entities Consolidated for Financial Reporting Purposes	35	164	185	2,427	2,811
<b>Total Consolidated Obligations and Commitments</b>	<b>\$ 903</b>	<b>\$ 251</b>	<b>\$ 514</b>	<b>\$ 2,708</b>	<b>\$ 4,376</b>

- (1) All consolidated ABS issued are collateralized by real estate loans and securities. Although the stated maturity is as shown, the ABS obligations will pay down as the principal balances of these real estate loans or securities pay down. The amount shown is the principal balance of the ABS issued and not necessarily the value reported in our consolidated financial statements.
- (2) The anticipated interest payments on consolidated ABS issued are calculated based on the contractual maturity of the ABS and therefore assume no prepayments of the principal outstanding at September 30, 2013.

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**Table of Contents****Potential GAAP Earnings Volatility**

We expect quarter-to-quarter GAAP earnings volatility from our business activities. This volatility can occur for a variety of reasons, including the timing and amount of purchases, sales, calls, and repayment of consolidated assets, changes in the fair values of consolidated assets and liabilities, increases or decreases in earnings from mortgage banking activities, and certain non-recurring events. In addition, the amount or timing of our reported earnings may be impacted by technical accounting issues, some of which are described below.

***Changes in Premium Amortization for Loans***

The net unamortized premium for loans owned at Redwood, consolidated Sequoia Entities, and the Commercial Securitization, was \$15 million at September 30, 2013. The amount of periodic premium amortization expense we recognize is volatile and dependent on a number of factors, including credit performance of the underlying loans, changes in prepayment speeds, and changes in short-term interest rates. Loan premium amortization was \$5 million and \$4 million for the nine months ended September 30, 2013 and 2012, respectively.

***Changes in Allowance for Loan Losses***

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

Changes in actual defaults or our expectations on loss severities and default timing can have a significant effect on periodic income.

***Changes in the Fair Value of Residential and Commercial Loans Held at Fair Value***

Nearly all of our unsecuritized residential loans on our consolidated balance sheet at September 30, 2013, were being held for future securitizations or sales and expected to be sold to non-consolidated securitization entities or third parties. At the time of purchase, we may elect the fair value option for these loans. For residential and commercial loans for which we have elected the fair value option, changes in fair values are recorded in mortgage banking activities, net, through the consolidated statements of income in the period in which the valuation change occurs. Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant period-to-period GAAP earnings volatility.

Loans classified as held-for-sale that are not carried at fair value are carried at the lower of their cost basis or fair value. If the fair value of loans is lower than their cost basis, the difference is reported as a negative market valuation adjustment through other market valuation adjustments, net, through the consolidated statements of income in the period in which the valuation change occurs.

The fair value of loans is affected by, among other things, changes in interest rates, credit performance, prepayments, and market liquidity. To the extent interest rates change or market liquidity and or credit conditions materially change, the value of these loans could decline below their cost basis, which could have a material effect on reported earnings.

***Changes in Yields for Securities***

The yields we project on real estate securities can have a significant effect on the periodic interest income we recognize for financial reporting purposes. Yields can vary as a function of credit results, prepayment rates, and interest rates. If estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected for assets acquired at a discount to principal balance), the yield over the remaining life of the security may be adjusted upwards. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected for assets acquired at a discount to principal balance), the yield over the remaining life of the security may be adjusted downward.

Changes in the actual maturities of real estate securities may also affect their yields to maturity. Actual maturities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of AFS securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than ten years. There is no assurance that our assumptions used to estimate future cash flows or the current period's yield for each asset will not change in the near term, and any change could be material.

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**Table of Contents*****Changes in Fair Values of Securities***

All securities owned at Redwood and consolidated entities are classified as either trading or AFS securities, and in both cases are carried on our consolidated balance sheets at their estimated fair values. For trading securities, changes in fair values are recorded in the consolidated statements of income. Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant GAAP earnings volatility each quarter.

For AFS securities, cumulative unrealized gains and losses are recorded as a component of accumulated other comprehensive income in our consolidated statements of changes in equity. Unrealized gains are not credited to current earnings and unrealized losses are not charged against current earnings to the extent they are temporary in nature. Certain factors may require us, however, to recognize declines in the values of AFS securities as other-than-temporary impairments and record them through our current earnings. Factors that determine other-than-temporary-impairment include a change in our ability or intent to hold AFS securities, adverse changes to projected cash flows of assets, or the likelihood that declines in the fair values of assets would not return to their previous levels within a reasonable time. Impairments on AFS securities can lead to significant GAAP earnings volatility each quarter. In addition, sales of securities in large unrealized gain or loss positions that are not impaired can lead to significant GAAP earnings volatility each quarter.

***Changes in Fair Values of Mortgage Servicing Rights***

Mortgage servicing rights are carried on our consolidated balance sheets at their estimated fair values, with changes in fair values recorded in the consolidated statements of income as a component of mortgage banking activities, net. Periodic fluctuations in the values of these investments are inherently volatile and can lead to significant GAAP earnings volatility each quarter. Periodic fluctuations in the values of our mortgage servicing rights can be caused by actual prepayments on the underlying loans, changes in assumptions regarding future projected prepayments on the underlying loans, or changes in the discount rate assumptions used to value mortgage servicing rights.

***Changes in Fair Values of Derivative Financial Instruments***

We can experience significant earnings volatility from our use of derivatives. We generally use derivatives as part of our mortgage banking activities (e.g., to manage risks associated with loans we plan to acquire and subsequently sell or securitize), and to manage variability in debt interest expense indexed to adjustable rates, and cash flows on assets and liabilities that have different coupon rates (fixed rates versus floating rates, or floating rates based on different indices). The nature of the instruments we use and the accounting treatment for the specific assets, liabilities, and derivatives may therefore lead to volatility in our periodic earnings, even when we are meeting our hedging objectives.

Some of our derivatives are accounted for as trading instruments with all associated changes in value recorded through our consolidated statements of income. Changes in value of the assets and liabilities we manage by using derivatives may not be accounted for similarly. This could lead to reported income and book values in specific periods that do not necessarily reflect the economics of our risk management strategy. Even when the assets and liabilities are similarly accounted for as trading instruments, periodic changes in their values may not coincide as other market factors (e.g., supply and demand) may affect certain instruments and not others at any given time.

***Changes in Loss Contingency Reserves***

We may be exposed to various loss contingencies, including, without limitation, those described in *Note 14* to the financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q. In accordance with FASB



guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish them when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. The establishment of a loss contingency reserve, the subsequent increase in a reserve or release of reserves previously established, or the recognition of a loss in excess of previously established reserves, can occur as a result of various factors and events that affect management's opinion of whether the standard for establishing, increasing, or continuing to maintain, a reserve has been met. Changes in the loss contingency reserves can lead to significant GAAP earnings volatility each quarter.

### ***Changes in Provision for Taxes***

Our quarterly tax provision is determined by multiplying actual year-to-date GAAP earnings by our estimated annual effective tax rate ( ETR ) and subtracting any tax expense recorded in prior quarters of the current year. The ETR is calculated by dividing the estimated annual tax expense by the estimated annual GAAP pre-tax earnings for the current year. Our estimated annual tax expense includes estimates for GAAP earnings, permanent and temporary book-to-tax differences, valuation allowances, and taxable income.

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Changes in our estimates and fluctuations in quarterly GAAP earnings can cause volatility in the quarterly tax provision. It is possible that a change in estimates could cause us to have a tax provision in one quarter and a tax benefit in a later quarter. Changes in the tax provision can lead to significant GAAP earnings volatility each quarter.

**Table of Contents****Results of Operations Taxable Income**

The following table summarizes our taxable income and distributions to shareholders for the three and nine months ended September 30, 2013 and 2012. For each of these periods, we had no undistributed REIT taxable income.

**Table 30 Taxable Income**

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013 <sup>(1)</sup>	2012	2013 <sup>(1)</sup>	2012
REIT taxable income	\$ 19,990	\$ 15,470	\$ 56,299	\$ 43,247
Taxable REIT subsidiary income (loss)	26,415	1,286	19,016	(791)
<b>Total Taxable Income</b>	<b>\$ 46,405</b>	<b>\$ 16,756</b>	<b>\$ 75,315</b>	<b>\$ 42,456</b>
Distributions to shareholders	\$ 23,052	\$ 20,340	\$ 68,922	\$ 59,743

(1) Our tax results for the three and nine months ended September 30, 2013 are estimates until we file the tax return for this year.

Our estimated total taxable income for the three months ended September 30, 2013, was \$46 million (\$0.56 per share) and included \$3 million in realized credit losses on investments. This compared to taxable income for the three months ended September 30, 2012, of \$17 million (\$0.21 per share) that included \$6 million in realized credit losses. Our estimated total taxable income for the nine months ended September 30, 2013, was \$75 million (\$0.92 per share) and included \$9 million in realized credit losses on investments. This compared to taxable income for the nine months ended September 30, 2012, of \$42 million (\$0.53 per share) that included \$21 million in credit losses.

For the three months ended September 30, 2013, we realized net capital gains of \$3 million at the REIT for tax purposes. For the nine months ended September 30, 2013, we realized net capital gains of \$6 million at the REIT for tax purposes. Net capital losses generated in 2013 by the REIT would have no effect on the taxability of our dividend. However, if the REIT were to generate realized net capital gains for the entire tax year, those gains would increase the portion of our dividend that is characterized as ordinary income to our shareholders.

For the three and nine months ended September 30, 2013, we recorded a tax benefit of \$5 million and a tax provision of \$9 million, respectively, for GAAP primarily related to mortgage banking activities at our TRS. Our third quarter of 2013 tax benefit primarily relates to a reduction of a valuation allowance at our taxable REIT subsidiaries. During the third quarter, we reduced the valuation allowance for capital loss carryforward deferred tax assets that were accumulated during past periods. We now expect to utilize this deferred tax asset within the carryforward period based on our revised expectation for realizing net capital gains on sales of appreciated securities. The year-to-date tax provision largely represents a future tax obligation rather than a corporate level current tax liability that will be paid in 2013. We are currently benefiting from favorable timing differences between when income associated with our mortgage banking activities is recognized for GAAP purposes versus when it is recognized for tax purposes, thus deferring a significant portion of the tax liability on that income. The mortgage banking income is not expected to be excess inclusion income, was not earned at the REIT, and will not affect the tax characterization of our 2013 dividends. Consistent with prior periods, we did not book a material tax provision associated with taxable income generated at our REIT.

***Differences between Estimated Taxable Income and GAAP Income***

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

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The tables below reconcile our estimated taxable income to our GAAP income for the three and nine months ended September 30, 2013 and 2012.

**Table 31 Differences between Estimated Taxable Income (Loss) and GAAP Net Income**

<b>(In Thousands, Except per Share Data)</b>	<b>Three Months Ended September 30, 2013</b>		
	<b>Tax (Est.)</b>	<b>GAAP</b>	<b>Differences</b>
Interest income	\$ 56,791	\$ 57,420	\$ (629)
Interest expense	(15,963)	(21,833)	5,870
Net interest income	40,828	35,587	5,241
Provision for loan losses	-	(1,727)	1,727
Realized credit losses	(2,757)	-	(2,757)
Other market valuation adjustments, net	-	462	(462)
Mortgage banking activities, net	28,508	(5,944)	34,452
Operating expenses	(20,169)	(21,853)	1,684
Realized gains, net	-	10,469	(10,469)
Benefit from (provision for) income taxes	(5)	4,935	(4,940)
<b>Net Income</b>	<b>\$ 46,405</b>	<b>\$ 21,929</b>	<b>\$ 24,476</b>
Income per share	\$ 0.56	\$ 0.25	\$ 0.31
<b>(In Thousands, Except per Share Data)</b>	<b>Three Months Ended September 30, 2012</b>		
	<b>Tax (Est.)</b>	<b>GAAP</b>	<b>Differences</b>
Interest income	\$ 43,086	\$ 59,723	\$ (16,637)
Interest expense	(6,318)	(28,285)	21,967
Net interest income	36,768	31,438	5,330
Provision for loan losses	-	(1,319)	1,319
Realized credit losses	(5,673)	-	(5,673)
Other market valuation adjustments, net	-	957	(957)
Mortgage banking activities, net	72	12,303	(12,231)
Operating expenses	(14,406)	(17,102)	2,696
Realized gains, net	-	13,940	(13,940)
Provision for income taxes	(5)	(516)	511
<b>Net Income</b>	<b>\$ 16,756</b>	<b>\$ 39,701</b>	<b>\$ (22,945)</b>
Income per share	\$ 0.21	\$ 0.48	\$ (0.27)
<b>(In Thousands, Except per Share Data)</b>	<b>Nine Months Ended September 30, 2013</b>		
	<b>Tax (Est.)</b>	<b>GAAP</b>	<b>Differences</b>
Interest income	\$ 158,456	\$ 168,664	\$ (10,208)
Interest expense	(42,129)	(61,651)	19,522

Net interest income	116,327	107,013	9,314
Provision for loan losses	-	(493)	493
Realized credit losses	(9,452)	-	(9,452)
Other market valuation adjustments, net	-	(6,099)	6,099
Mortgage banking activities, net	25,205	98,608	(73,403)
Operating expenses	(56,521)	(65,095)	8,574
Realized gains, net	-	23,291	(23,291)
Provision for income taxes	(244)	(9,113)	8,869
<b>Net Income</b>	<b>\$ 75,315</b>	<b>\$ 148,112</b>	<b>\$ (72,797)</b>
Income per share	\$ 0.92	\$ 1.65	\$ (0.73)

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(In Thousands, Except per Share Data)	Nine Months Ended September 30, 2012		
	Tax (Est.)	GAAP	Differences
Interest income	\$ 122,973	\$ 177,988	\$ (55,015)
Interest expense	(18,072)	(87,822)	69,750
Net interest income	104,901	90,166	14,735
Provision for loan losses	-	(254)	254
Realized credit losses	(21,408)	-	(21,408)
Other market valuation adjustments, net	-	(402)	402
Mortgage banking activities, net	(470)	13,642	(14,112)
Operating expenses	(40,553)	(46,900)	6,347
Realized gains, net	-	34,555	(34,555)
Provision for income taxes	(14)	(1,116)	1,102
<b>Net Income</b>	<b>\$ 42,456</b>	<b>\$ 89,691</b>	<b>\$ (47,235)</b>
Income per share	\$ 0.53	\$ 1.09	\$ (0.56)

**Potential Taxable Income Volatility**

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

**Credit Losses on Securities and Loans**

To determine estimated taxable income, we are generally not permitted to anticipate, or reserve for, credit losses on investments which are generally purchased at a discount. For tax purposes, we accrue the entire purchase discount on a security into taxable income over the expected life of the security. Estimated taxable income is reduced when actual credit losses occur. For GAAP purposes, we establish a credit reserve and only accrete a portion of the purchase discount, if any, into income and write-down securities that become impaired. Our income recognition is therefore faster for tax as compared to GAAP, especially in the early years of owning a security (when there are generally few credit losses). At September 30, 2013, the cumulative difference between the GAAP and tax amortized cost basis of our residential subordinate securities (excluding our investments in our securitization entities) was \$46 million.

As we have no credit reserves or allowances for tax, any future credit losses on securities or loans will have a more significant impact on tax earnings than on GAAP earnings and may create significant taxable income volatility to the extent the level of credit losses fluctuates during reporting periods. During the three months ended September 30, 2013 and 2012, we realized \$3 million and \$6 million, respectively, of credit losses on securities for tax that we had previously provisioned for under GAAP. During the nine months ended September 30, 2013 and 2012, we realized \$9 million and \$21 million, respectively, of credit losses on securities for tax that we had previously provisioned for under GAAP. We anticipate that credit losses will continue to be a significant factor for determining 2013 taxable income. Credit losses are based on our tax basis, which differs materially from our basis for GAAP purposes. We anticipate an additional \$69 million of credit losses for tax on securities, based on our projection of principal balance losses and assuming a similar tax basis as we have recently experienced, although the timing of actual losses is difficult to accurately project. At September 30, 2013, for GAAP we had a designated credit reserve of \$136 million on our securities, and an allowance for loan losses of \$30 million for our consolidated residential and commercial loans.

***Recognition of Gains and Losses on Sale***

Since amortization and impairments on assets differ for tax and GAAP, the tax and GAAP basis on assets sold or called may differ, resulting in differences in gains and losses on sale or call. In addition, gains realized for tax may be offset by prior capital losses and, thus, not affect taxable income. At September 30, 2013, the REIT had an estimated \$295 million in capital loss carryforwards (\$3.58 per share) that can be used to offset future capital gains over the next three to five years. Since our intention is to generally make long-term investments, it is difficult to anticipate when sales may occur and, thus, when or whether we might exhaust these capital loss carryforwards. At September 30, 2013, we had an estimated \$25 million in capital loss carryforwards at the TRS level. We anticipate selling most of our portfolio of appreciated IO securities within the capital loss carryforward period. Consequently, although not certain, it is likely that the TRS will benefit from the use of the capital loss carryforwards.



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**Table of Contents*****Prepayments on Securities***

As part of our investment in Sequoia securitization entities, we have retained IOs at the time they were issued. Our tax basis in these securities was \$94 million at September 30, 2013, which includes a tax basis of \$81 million for IOs retained from securitizations completed in 2010 and later. The return on IOs is sensitive to prepayments and, to the extent prepayments vary period to period, income from these IOs will vary. Typically, fast prepayments reduce yields and slow prepayments increase yields. We are not permitted to recognize a negative yield under tax accounting rules, so during periods of fast prepayments our periodic premium expense for tax purposes can be relatively low and the tax cost basis for these securities may not be significantly reduced. In periods prior to 2008, we experienced fast prepayments on the loans underlying our IOs. More recently, prepayments on loans owned at consolidated Sequoia entities issued prior to 2010 have been slow, and our tax basis is now below the fair values for these IOs in the aggregate. Most of the Sequoia securitizations consolidated by us are callable or will become callable over the next two years. If a Sequoia securitization is called, the remaining tax basis in the IO is expensed, creating an ordinary loss at the call date.

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

***Compensation Expense***

The total tax expense for equity award compensation is dependent upon varying factors such as the timing of payments of dividend equivalent rights, the exercise of stock options, the distribution of deferred stock units and preferred stock units, and the cash deferrals to and withdrawals from our Executive Deferred Compensation Plan. For GAAP purposes, the total expense associated with an equity award is determined at the award date and is recognized over the vesting period. For tax, the total expense is recognized at the date of distribution or exercise, not the award date. In addition, some compensation may not be deductible for tax if it exceeds certain levels and is not performance-based. Thus, the total amount of compensation expense, as well as the timing, could be significantly different for tax than for GAAP.

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

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

***Mortgage Servicing Rights***

For GAAP purposes, we recognize MSR assets through the acquisition of servicing rights from third parties or through the retention of MSR assets associated with residential loans that we have acquired and subsequently transferred to non-consolidated securitization entities or to third parties. For tax purposes, basis in our MSR assets is recognized through the acquisition of servicing rights from third parties, or to the extent that the MSR entitles us to receive a servicing fee that is in excess of a safe harbor amount prescribed by the Internal Revenue Service. Tax basis in our MSR assets is not recognized when MSR assets are retained from transfers of loans to non-consolidated securitization entities or to third parties thereby creating a temporary GAAP to tax difference on the gain from sale. For the three and nine months ended September 30, 2013, we purchased \$3 million of MSR assets on conforming loans that were recognized for tax purposes. No other tax basis in our MSR assets has been recognized to date.

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

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### **Critical Accounting Policies**

See the *Critical Accounting Policies* section in *Management's Discussion and Analysis of Financial Condition and Results of Operations*, as well as *Note 3* to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2012, for a detailed discussion of the Company's critical accounting policies. Any changes to our critical accounting policies or the methodologies or assumptions we apply under them are noted in *Note 3* to the consolidated financial statements presented in this Quarterly Report on Form 10-Q. We also describe in *Note 3* certain recent accounting pronouncements that will amend the critical accounting policies we apply in future periods.

### **Market Risks**

We seek to manage risks inherent in our business including but not limited to credit risk, interest rate risk, prepayment risk, liquidity risk, and fair value risk in a prudent manner designed to enhance our earnings and dividends and preserve our capital. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, and to maintain capital levels consistent with these risks. This section presents a general overview of these risks. Additional information concerning the risks we are managing, how these risks are changing over time, and potential GAAP earnings and taxable income volatility we may experience as a result of these is further discussed above in this *Management's Discussion and Analysis of Financial Condition and Results of Operations*.

### ***Credit Risk***

Integral to our business is assuming credit risk through our ownership of residential and commercial loans and securities as well as through our reliance on business counterparties. We believe the securities and loans we purchase are priced to generate an expected return that compensates us for the underlying credit risk associated with these investments. Nevertheless, there may be significant credit losses associated with these investments should they perform worse than we expect on a credit basis.

We manage our credit risks by analyzing the extent of the risk we are taking and reviewing whether we believe the appropriate underwriting criteria are met, and we utilize systems and staff to monitor the ongoing credit performance of our loans and securities. To the extent we find the credit risks on specific assets are changing adversely, we may be able to take actions, such as selling the affected investments, to mitigate potential losses. However, we may not always be successful in analyzing risks, reviewing underwriting criteria, foreseeing adverse changes in credit performance or in effectively mitigating future credit losses and the ability to sell an asset may be limited due to the structure of the asset or the absence of a liquid market for the asset.

### ***Residential Loans and Securities***

Our residential loans and securities backed by residential loans are generally secured by real property. Credit losses on real estate loans and securities can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; decline in the value of homes, businesses, or commercial properties; special hazards; earthquakes and other natural events; over-leveraging of the borrower or on the property; reduction in market rents and occupancies and poor property management practices; changes in legal protections for lenders; reduction in personal incomes; job loss; and personal events such as divorce or health problems. In addition, if the U.S. economy or the housing market were to weaken (and that weakening was in excess of what we anticipated), credit losses could increase beyond levels that we have anticipated.

With respect to some of the loans securitized by securitization entities sponsored by us and for a portion of the loans underlying residential loan securities we have acquired from securitizations sponsored by others, the interest rate is adjustable. Accordingly, when short-term interest rates rise, required monthly payments from homeowners may rise under the terms of these loans, and this may increase borrowers' delinquencies and defaults that can lead to additional credit losses.

We also own some securities backed by Alt-A quality loans (and, to a lesser degree, some backed by subprime loans) that have substantially higher credit risk characteristics than prime-quality loans. Consequently, we can expect these lower-quality loans to have higher rates of delinquency and loss, and if such losses differ from our assumptions, we could incur credit losses. In addition, we invest in riskier loan types with the potential for higher delinquencies and losses as compared to regular amortization loans, but believe these securities offer us the opportunity to generate attractive risk-adjusted returns as a result of attractive pricing and the manner in which these securitizations are structured. Nevertheless, there remains substantial uncertainty about the future performance of these assets.

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**Table of Contents***Commercial Loans and Securities*

The commercial loans we invest in are typically fixed-rate loans. The majority of the mezzanine loans we invest in are interest-only loans that are generally subordinate to senior lien holders and are backed by a transaction sponsor or borrowing entity and not real property. The commercial securities we invest in are typically subordinate securities backed by first-lien commercial loans that credit enhance more senior securities backed by the same loans and may thus expose us to a more concentrated credit risk than other investors. In general, the loans we invest in or the loans backing securities that we credit enhance require balloon payments at maturity. Consequently, we could be exposed to credit losses at the maturity of these loans if the borrower is unable to repay or refinance the borrowing with another third-party lender. The ability of the borrower to pay us back at maturity is a function of the cash flows generated on the commercial property, as well as the general level of interest rates. If interest rates rise to an extent that the cash flows on the property are insufficient to cover a new loan that is sufficient to pay off our loan, we would be subject to credit losses at maturity.

In addition, we originate commercial loans secured by first liens on commercial real estate with the intention to sell these loans or securitize them within a relatively short period of time following origination. Between the time of origination and the time of sale or securitization of these senior loans, we are exposed to credit risk associated with these loans. In addition, we may, in some circumstances, invest in a subordinate security issued in a securitization transaction that includes one or more senior loans we originated, in which case we would continue to be exposed to credit risk with respect to these and other loans included in that securitization through our ownership of those subordinate securities.

*Counterparties*

We are also exposed to credit risk with respect to our business and lender counterparties. For example, counterparties we acquire loans from, lend to, or invest in, make representations and warranties and covenants to us, and may also indemnify us against certain losses. To the extent we have suffered a loss and are entitled to enforce those agreements to recover damages, if our counterparties are insolvent or unable or unwilling to comply with these agreements we would suffer a loss due to the credit risk associated with our counterparties. As an additional example, under short-term borrowing facilities and swap and other derivative agreements, we sometimes transfer assets as collateral to our counterparties. To the extent a counterparty is not able to return this collateral to us if and when we are entitled to its return, we could suffer a loss due to the credit risk associated with that counterparty.

In addition, because we rely on the availability of credit under committed and uncommitted borrowing facilities to fund our business and investments, our counterparties' willingness and ability to extend credit to us under these facilities is a significant counterparty risk (and is discussed further below under the heading *Fair Value and Liquidity Risks* ).

*Interest Rate Risk*

Changes in interest rates and the shape of the yield curve can affect the cash flows and fair values of our assets, liabilities, and derivative financial instruments and, consequently, affect our earnings and reported equity. Our general strategy with respect to interest rates is to maintain an asset/liability posture (including hedges) on a consolidated basis that assumes some interest rate risks but not to such a degree that the achievement of our long-term goals would likely be adversely affected by changes in interest rates. Accordingly, we are willing to accept short-term volatility of earnings and changes in our reported equity in order to accomplish our goal of achieving attractive long-term returns.

To implement our interest rate risk management strategy, we may use derivative financial instruments in an effort to maintain a close match between pledged assets and debt, as well as between the interest rate characteristics of the assets in the securitization entities and the corresponding ABS issued. However, we generally do not attempt to completely hedge changes in interest rates, and at times, we may be subject to more interest rate risk than we generally desire in the long term. Changes in interest rates will have an impact on the values and cash flows of our assets and corresponding liabilities. A further discussion of risks relating to recent changes in the interest rate environment is set forth above in *Management's Discussion and Analysis of Financial Condition and Results of Operations* under *Financial Results - Third Quarter 2013*.

***Prepayment Risk***

Prepayment risks exist in the assets and associated liabilities consolidated on our balance sheets. In general, discount securities benefit from faster prepayment rates on the underlying real estate loans while premium securities (such as IOs) and MSRs benefit from slower prepayments on the underlying loans. We note that changes in residential loan prepayment rates could result in GAAP and tax earnings volatility.

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We caution that prepayment rates are difficult to predict or anticipate, and variations in prepayment rates can materially affect our earnings and dividend distribution requirements. ARM prepayment rates, for example, are driven by many factors, one of which is the steepness of the yield curve. As the yield curve flattens (short-term interest rates rise relative to longer-term interest rates), ARM prepayments typically increase. However, for borrowers who have impaired credit or who otherwise do not meet loan underwriting criteria, the ability to refinance (i.e., prepay) a loan even when interest rates decline may be limited.

***Inflation Risk***

Virtually all of our consolidated assets and liabilities are financial in nature. As a result, changes in interest rates and other factors drive our performance more directly than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Separately, inflation or deflation in home prices can affect our credit risk.

***Fair Value and Liquidity Risks***

To fund our assets we may use a variety of debt alternatives in addition to equity capital that present us with fair value and liquidity risks. We seek to manage these risks, including by maintaining what we believe to be adequate cash and capital levels.

Most residential loans we invest in are accumulated and sold to Sequoia securitization entities and thus, changes in the fair value of the loans, once securitized, do not have an impact on our liquidity. However, changes in fair values during the accumulation period (while these loans are typically funded with short-term debt before they are sold to a Sequoia entity) may have a short-term effect on our liquidity. We may also own some real estate loans accounted for as held-for-sale and adverse changes in their value may be recognized through our income statement and may have an impact on our ability to obtain financing for them.

Most of the securities we invest in are funded with a combination of equity capital, secured financing or other debt facilities. To the extent we use equity capital or secured financing, we can reduce our liquidity risks; however, we would still be exposed to adverse changes in fair value of these securities as a result of changes in overall market liquidity. For the securities we acquire with a combination of equity capital and short-term debt, we would be exposed to liquidity risk to the extent the values of these investments decline and/or the counterparties we use to finance these investments adversely change our borrowing requirements. We attempt to mitigate our liquidity risk from short-term financing facilities by setting aside adequate capital.

Under short-term borrowing facilities, interest rate swaps and other derivatives agreements, we pledge assets as security for our payment obligations and make various representations and warranties and agree to certain covenants, events of default, and other terms. In addition, our short-term borrowing facilities are generally uncommitted, meaning that each time we request a new borrowing under a facility the lender has the option to decline to extend credit to us. The terms of these facilities and agreements typically include financial covenants (such as covenants to maintain a minimum amount of tangible net worth or stockholders' equity and/or a minimum amount of liquid assets), margin requirements (which typically require us to pledge additional collateral if and when the value of previously pledged collateral declines), operating covenants (such as covenants to conduct our business in accordance with applicable laws and regulations and covenants to provide notice of certain events to creditors), representations and warranties (such as representations and warranties relating to characteristics of pledged collateral, our exposure to litigation and/or regulatory enforcement actions and the absence of material adverse changes to our financial condition, our operations, or our business prospects), and events of default (such as a breach of covenant or representation/warranty and cross-defaults, under which an event of default is triggered under a credit facility if an event of default or similar

event occurs under another credit facility).

**Risks Relating to Short-Term Debt Incurred Under Residential Mortgage Loan Warehouse Facilities, Securities Repurchase Facilities, and Other Short-Term Debt Facilities; and Risks Relating to Debt Incurred Under Commercial Debt Investment Repurchase Facilities**

As described above under the heading *Results of Operations* Redwood (Parent), in the ordinary course of our business, we use debt financing obtained through several different types of borrowing facilities to, among other things, finance the acquisition of residential mortgage loans we acquire (including those we acquire in anticipation of sale or securitization), finance commercial mortgage loans we originate (including those we originate in anticipation of sale or securitization), finance the other commercial debt investments we originate and acquire, and finance investments in securities and other investments. We may also use short-term borrowings to fund other aspects of our business and operations.

*Residential Loan Warehouse Facilities.* One source of our short-term debt financing is secured borrowings under residential loan warehouse facilities that are in place with five different financial institution counterparties. Under these five warehouse facilities, we had an aggregate borrowing limit of \$1.65 billion at September 30, 2013; however, these facilities are uncommitted, which means that any request we make to borrow funds under these facilities may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under these facilities. Short-term financing for



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residential mortgage loans is obtained under these facilities by our transfer of mortgage loans to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred mortgage loans), and our covenant to reacquire those loans from the counterparty for the same amount plus a financing charge.

In order to obtain financing for a residential loan under these facilities, the loan must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the loan is not in a delinquent status. In addition, under these warehouse facilities, residential loans can only be financed for a maximum period, which period would not generally exceed 364 days. We generally intend to repay the short-term financing of a loan under one of these facilities at or prior to the expiration of that financing with the proceeds of a securitization or other sale of that loan, through the proceeds of other short-term borrowings, or with other equity or long-term debt capital. While a residential loan is financed under a warehouse facility, to the extent the market value of the loan declines (which market value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the loan or meet a margin requirement to pledge additional collateral, such as cash or additional residential loans, in an amount at least equal to the decline in value. See further discussion below under the heading *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*.

Because these warehouse facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*. In addition, with respect to residential loans that at any given time are already being financed through these warehouse facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*, if and when those loans become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the applicable facility.

Under our residential loan warehouse facilities, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under these facilities and these facilities being unavailable to use for future financing needs. In particular, the terms of these facilities include financial covenants, cross-default provisions, judgment default provisions, and other events of default (such as, for example, events of default triggered by one of the following: a change in control over Redwood, regulatory investigation or enforcement action against Redwood, Redwood's failure to continue to qualify as a REIT for tax purposes, or Redwood's failure to maintain the listing of its common stock on the New York Stock Exchange). Under a cross-default provision, an event of default is triggered (and the warehouse facility becomes unavailable and outstanding amounts borrowed thereunder become due and payable) if an event of default or similar event occurs under another borrowing or credit facility we maintain in excess of a specified amount. Under a judgment default provision, an event of default is triggered (and the warehouse facility becomes unavailable and outstanding amounts borrowed thereunder become due and payable) if a judgment for damages in excess of a specified amount is entered against us in any litigation and we are unable to promptly satisfy the judgment. Financial covenants included in these warehouse facilities are further described below under the heading *Financial Covenants Associated With Short-Term Debt and Other Debt Financing*.

These residential loan warehouse facilities could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of our warehouse facilities, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*.

In addition to the five residential loan warehouse facilities described above, in the ordinary course of business we may seek to establish additional warehouse facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a counterparty to one or more of our warehouse facilities becomes insolvent or unable or unwilling to perform its obligations under the facility, we may be unable to access short-term financing we need or fail to recover the full value of our residential mortgage loans financed.

*Securities Repurchase Facilities.* Another source of short-term debt financing is through securities repurchase facilities we have established with various different financial institution counterparties. Under these facilities we do not have an aggregate borrowing limit; however, these facilities are uncommitted, which means that any request we make to borrow funds under these facilities may be declined for any reason. Short-term financing for securities is obtained under these facilities by our transfer of securities to the counterparty in exchange for cash proceeds (in an amount less than 100% of the fair value of the transferred securities), and our covenant to reacquire those securities from the counterparty for the same amount plus a financing charge.

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Under these securities repurchase facilities, securities are financed for a fixed period, which would not generally exceed 90 days. We generally intend to repay the short-term financing of a security under one of these facilities through a renewal of that financing with the same counterparty, through a sale of the security, or with other equity or long-term debt capital. While a security is financed under a securities repurchase facility, to the extent the value of the security declines (which value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the security or meet a margin requirement to pledge additional collateral, such as cash or U.S. Treasury securities, in an amount at least equal to the decline in value. See further discussion below under the heading *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*.

At the end of the fixed period applicable to the financing of a security under a securities repurchase facility, if we intend to continue to obtain financing for that security we would typically request the same counterparty to renew the financing for an additional fixed period. If the same counterparty does not renew the financing, it may be difficult for us to obtain financing for that security under one of our other securities repurchase facilities, due to the fact that the financial institution counterparties to our securities repurchase facilities generally only provide financing for securities that we purchased from them or one of their affiliates.

Because our securities repurchase facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*. In addition, with respect to securities that at any given time are already being financed through our securities repurchase facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*, if and when those securities decline in value, or have been financed for the maximum term permitted under the applicable facility.

Under our securities repurchase facilities, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms (including of the type described above under the heading *Residential Loan Warehouse Facilities* ) that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under these facilities and these facilities being unavailable to use for future financing needs. In particular, the terms of these facilities include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading *Residential Loan Warehouse Facilities* ). Financial covenants included in our repurchase facilities are further described below under the heading *Financial Covenants Associated With Short-Term Debt and Other Debt Financing*.

Our securities repurchase facilities could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of our securities repurchase facilities, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*.

In the ordinary course of business we may seek to establish additional securities repurchase facilities that may have similar or more restrictive terms. In the event a counterparty to one or more of our securities repurchase facilities becomes insolvent or unable or unwilling to perform its obligations under the facility, we may be unable to access the short-term financing we need or fail to recover the full value of our securities financed.

*Commercial Mortgage Loan Warehouse Facility*. Another source of short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility we established in April 2013 with a financial institution

counterparty. Under this warehouse facility, we have an aggregate borrowing limit of \$100 million; however, this facility is uncommitted, which means that any request we make to borrow funds under this facility may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under this facility. Short-term financing for commercial mortgage loans is obtained under this facility by our transfer of commercial mortgage loans to a special purpose entity which transfers them to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred commercial mortgage loans), and our covenant to reacquire those commercial mortgage loans from the counterparty for the same amount plus a financing charge. Other periodic payments are also due under the facility.

In order to obtain financing for a commercial mortgage loan under this facility, the commercial mortgage loan must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the commercial mortgage loan is not in a delinquent status. In addition, under this facility, a commercial mortgage loan can only be financed for a maximum period, which period would not generally exceed 180 days. We generally intend to repay the short-term financing of a commercial mortgage loan under this facility at or prior to the expiration of the financing term with the proceeds of a sale or securitization of that commercial mortgage loan, through the proceeds of other short-term borrowings, or with other equity or

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long-term debt capital. While a commercial mortgage loan is financed under this facility, to the extent the market value of the commercial mortgage loan declines (which market value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the commercial mortgage loan or meet a margin requirement to pledge additional collateral, such as cash or additional commercial mortgage loans, in an amount at least equal to the decline in value. See further discussion below under the heading *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*.

Because this warehouse facility is uncommitted, at any given time we may not be able to obtain additional financing under this facility when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*. In addition, with respect to commercial mortgage loans that at any given time are already being financed through this facility, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*, if and when those commercial mortgage loans become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the facility.

Under our commercial mortgage loan warehouse facility, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. In particular, the terms of this facility include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading *Residential Loan Warehouse Facilities*). Financial covenants included in this warehouse facility are further described below under the heading *Financial Covenants Associated With Short-Term Debt and Other Debt Financing*.

Our commercial mortgage loan warehouse facility could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of this facility, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*.

In addition to the commercial mortgage loan warehouse facility described above, in the ordinary course of business we may seek to establish additional facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a counterparty to one or more of our facilities becomes insolvent or unable or unwilling to perform its obligations under a facility, we may be unable to access the financing we need or we may fail to recover the full value of our commercial mortgage loans financed under the applicable facility.

*Other Short-Term Debt Facilities.* We also maintain a \$10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. This bank line of credit is an additional source of short-term financing for us. Similar to the uncommitted warehouse and securities repurchase facilities described herein, under this committed line we make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. The margin call provisions and financial covenants included in this committed line are further described below under the headings *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing* and *Financial Covenants Associated with Short-Term Debt and Other Debt Financing*. When we use this committed line to incur short-term debt we are exposed to the market, credit, liquidity, and other types of risks

described above with respect to residential loan warehouse and securities repurchase facilities.

*Commercial Debt Investment Repurchase Facility.* Another source of debt financing is secured borrowings through a commercial debt investment repurchase facility that is in place with a financial institution counterparty. Under this repurchase facility, we have an aggregate borrowing limit of \$150 million; however, any request we make to borrow funds under this facility secured by a particular commercial debt investment may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under this facility. Financing for commercial debt investments is obtained under this facility by our transfer of commercial debt investments to a special purpose entity which is beneficially owned by the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred commercial debt investments), and our covenant to reacquire those commercial debt investments for the same amount plus a financing charge. Other periodic payments are also due under the facility.

In order to obtain financing for a commercial debt investment under this facility, the commercial debt investment must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the commercial debt investment is not in a delinquent status. This facility has a three-year term. We generally intend to repay the

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financing of a commercial debt investment under this facility at or prior to the expiration of the financing term with the proceeds of a securitization or other sale of that commercial debt investment, or with other equity or long-term debt capital. While a commercial debt investment is financed under this facility, to the extent the value of the commercial debt investment declines (which value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the commercial debt investment or meet a margin requirement to pledge additional collateral, such as cash or additional commercial debt investments, in an amount at least equal to the decline in value. See further discussion below under the heading *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*.

Because the counterparty under this facility retains discretion to accept or reject a financing with respect to any particular commercial debt investment, at any given time we may not be able to obtain additional financing under this facility when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*. In addition, with respect to commercial debt investments that at any given time are already being financed through this facility, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*, if and when those commercial debt investments become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the facility.

Under our commercial debt investment repurchase facility, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. In particular, the terms of this facility include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading *Residential Loan Warehouse Facilities* ). Financial covenants included in our repurchase facilities are further described below under the heading *Financial Covenants Associated With Short-Term Debt and Other Debt Financing*.

Our commercial debt investment repurchase facility could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of this facility, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, under the heading *Risk Factors*, and above under the heading *Market Risks*.

In addition to the commercial debt investment repurchase facility described above, in the ordinary course of business we may seek to establish additional facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a counterparty to one or more of our facilities becomes insolvent or unable or unwilling to perform its obligations under a facility, we may be unable to access the financing we need or we may fail to recover the full value of our commercial debt investments financed under the applicable facility.

**Financial Covenants Associated With Short-Term Debt and Other Debt Financing**

Set forth below is a summary of the financial covenants associated with our short-term debt and other debt financing facilities.

Residential Loan Warehouse Facilities. As noted above, one source of our short-term debt financing is secured borrowings under residential loan warehouse facilities we have established with five different financial institution counterparties. Financial covenants included in these warehouse facilities are as follows and at September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- i Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
  
- i Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood or maintenance of an amount of cash and cash equivalents in excess of a specified percentage of outstanding short-term recourse indebtedness.
  
- i Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity and tangible net worth at Redwood.
  
- i Maintenance of uncommitted residential loan warehouse facilities with a specified level of unused borrowing capacity.



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Securities Repurchase Facilities. As noted above, another source of our short-term debt financing is through secured borrowings under securities repurchase facilities we have established with various financial institution counterparties. Financial covenants included in these securities repurchase facilities are as follows and at September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- i Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
- i Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.
- i Maintenance of a minimum ratio of consolidated recourse indebtedness to consolidated adjusted tangible net worth at Redwood.

Commercial Mortgage Loan Warehouse Facility. As noted above, another source of our short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility we established in April 2013 with a financial institution counterparty. Financial covenants included in this facility are as follows and, at September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- o Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
- o Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.
- o Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity at Redwood, including a separate minimum ratio for commercial assets which is applicable under certain specified circumstances.

Committed Line of Credit. As noted above, we also maintain a \$10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. The types of financial covenants included in this bank line of credit are a subset of the covenants summarized above.

Commercial Debt Investment Repurchase Facility. As noted above, one source of our debt financing is secured borrowings under a commercial debt investment repurchase facility we have established with a financial institution counterparty. Financial covenants included in this facility are as follows and at September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- o Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.

- o Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.

- o Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity at Redwood. As noted above, at September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with the financial covenants associated with our short-term debt and other debt financing facilities. In particular, with respect to: (i) financial covenants that require us to maintain a minimum dollar amount of stockholders' equity or tangible net worth, at September 30, 2013 our level of stockholders' equity and tangible net worth resulted in our being in compliance with these covenants by more than \$200 million; and (ii) financial covenants that require us to maintain recourse indebtedness below a specified ratio, at September 30, 2013 our level of recourse indebtedness resulted in our being in compliance with these covenants at a level such that we could incur at least \$1 billion in additional recourse indebtedness.

Margin Call Provisions Associated With Short-Term Debt and Other Debt Financing

Residential Loan Warehouse Facilities. As noted above, one source of our short-term debt financing is secured borrowings under residential loan warehouse facilities we have established with five different financial institution counterparties. These warehouse facilities include the margin call provisions described below and during the three months ended September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from creditors under these warehouse facilities:

- o If at any time the market value (as determined by the creditor) of any residential mortgage loan financed under a facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations (in certain cases), or additional residential mortgage loans) with a value equal to the amount of the decline. If we receive any such demand, (i) under three of our residential loan warehouse facilities, we would generally be

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required to transfer the additional collateral on the same day (although demands received after a certain time would only require the transfer of additional collateral on the following business day) and (ii) under two of our residential loan warehouse facilities, we would generally be required to transfer the additional collateral on the following business day. The value of additional residential mortgage loans transferred as additional collateral is determined by the creditor.

**Securities Repurchase Facilities.** As noted above, another source of our short-term debt financing is secured borrowings under securities repurchase facilities we have established with various financial institution counterparties. These repurchase facilities include the margin call provisions described below and during the three months ended September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from creditors under these repurchase facilities:

- o If at any time the market value (as determined by the creditor) of any securities financed under a facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations, or additional securities) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the same day. The value of additional securities transferred as additional collateral is determined by the creditor.

**Commercial Mortgage Loan Warehouse Facility.** As noted above, another source of our short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility we established in April 2013 with a financial institution counterparty. This facility includes the margin call provisions described below and during the three months ended September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from the creditor under this facility:

- o If at any time the market value (as determined by the creditor) of any commercial mortgage loan financed under the facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash or additional commercial mortgage loans) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the following business day. The value of additional commercial mortgage loans transferred as additional collateral is determined by the creditor.

**Committed Line of Credit.** As noted above, we also maintain a \$10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. Margin call provisions included in this bank line of credit are as follows and during the three months ended September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from this creditor under this line of credit:

- o If at any time the total market value (as determined by two broker-dealers) of the securities that are pledged as collateral under this facility declines to a value less than the outstanding amount of borrowings under this facility, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations, or additional securities) with a value equal to the amount of the difference. If we receive any such demand, we would generally be required to transfer the additional collateral within two business days. The value of additional collateral pledged is determined by the creditor.

Commercial Debt Investment Repurchase Facility. As noted above, one source of our debt financing is secured borrowings under a commercial debt investment repurchase facility we have established with a financial institution counterparty. This facility includes the margin call provisions described below and during the three months ended September 30, 2013, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from the creditor under this facility:

- o If at any time the asset value (as determined by the creditor) of any commercial debt investment financed under the facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash or additional commercial debt investments) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the second business day thereafter (although demands received after a certain time would allow an additional business day for the transfer of additional collateral to occur). The value of additional commercial debt investments transferred as additional collateral is determined by the creditor.

#### **Other Risks**

In addition to the market and other risks described above, our business and results of operations are subject to a variety of types of risks and uncertainties, including, among other things, those described under the caption *Risk Factors* in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 and in Part II, Item 1A of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2013.

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Information concerning market risk is incorporated herein by reference to Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012, as supplemented by the information under *Management's Discussion and Analysis of Financial Condition and Results of Operations*, *Business Update* and *Market Risks* within Item 2 above and under *Risk Factors* in Part II, Item 1A of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2013. Other than the developments described thereunder, including changes in the fair values of our assets, there have been no other material changes in our quantitative or qualitative exposure to market risk since December 31, 2012.

**Item 4. Controls and Procedures**

We have adopted and maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed on our reports under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized, and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms and that the information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) of the Exchange Act, we have carried out an evaluation, under the supervision and with the participation of management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at a reasonable assurance level.

There have been no changes in our internal control over financial reporting during the third quarter of 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the Seattle Certificate) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the 2005-4 RMBS) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys' fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, as of September 30, 2013, the FHLB-Seattle has received approximately \$113.3 million of principal and \$11.0 million of interest payments in respect of the Seattle Certificate. As of September 30, 2013, the Seattle Certificate had a remaining outstanding principal amount of approximately \$20.2 million. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle's claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (Schwab) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the Schwab Defendants) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the Schwab Certificate) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. Schwab alleges a claim for negligent misrepresentation under California state law and seeks unspecified damages and attorneys' fees and costs. The Schwab Certificate was issued with an original principal amount of approximately \$14.8 million, and, as of September 30, 2013, Schwab has received approximately \$12.6 million of principal and \$1.3 million of interest payments in respect of the Schwab Certificate. As of September 30, 2013, the Schwab Certificate had a remaining outstanding principal amount of approximately \$2.2 million. 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,

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as of September 30, 2013, the FHLB Chicago has received approximately \$71.5 million of principal and \$24.0 million of interest payments in respect of this Chicago Certificate. As of September 30, 2013, this Chicago Certificate had a remaining outstanding principal amount of approximately \$32.8 million (after taking into account approximately \$0.9 million of principal losses allocated to this Chicago Certificate). The second of the Chicago Certificates was issued with an original principal amount of approximately \$379 million and, as of September 30, 2013, the FHLB Chicago has received approximately \$256.1 million of principal and \$80.7 million of interest payments in respect of this Chicago Certificate. As of September 30, 2013, this Chicago Certificate had a remaining outstanding principal amount of approximately \$116.7 million (after taking into account approximately \$6.0 million of principal losses allocated to 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.

In May 2010, we received an Order from the SEC, pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. The SEC's Order required us to provide information regarding, among other things, our trading practices and valuation policies relating to our business of sponsoring and managing collateralized debt obligation issuers. We have responded to the Order. The Order from the SEC indicates that it should not be construed as an indication by the SEC or its staff that any violations of law have occurred. The SEC could, however, as a result of our response to this Order or otherwise, allege that we violated applicable law or regulation in the conduct of our collateralized debt obligation business.

In November 2009, we received a subpoena from the National Credit Union Administration (NCUA), which is the federal agency that charters and supervises federal credit unions, as part of its investigation of the circumstances relating to the U.S. Central Federal Credit Union being placed into conservatorship in March 2009, including the U.S. Central Federal Credit Union's investment in various RMBS. The NCUA requested information relating to, among other things, two RMBS (i) issued by a securitization trust with respect to which SRF was the depositor and (ii) purchased at the time of issuance by the U.S. Central Federal Credit Union. We have responded to the subpoena. The subpoena from the NCUA states that it should not be construed as an indication by the NCUA or its staff that any violation of law has occurred. The NCUA could, however, as a result of our response to this subpoena or otherwise, allege that we did violate applicable law or regulation in the conduct of our securitization business.

Other than as disclosed in the preceding paragraphs of this Item 1, there are no material pending legal proceedings, or material changes with respect to pending legal proceedings, in each case, to which we or any of our subsidiaries is a party or of which our property is the subject.

**Item 1A. Risk Factors**

Our risk factors are discussed under Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012 and under Part II, Item 1A of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2013.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

During the three months ended September 30, 2013, we did not sell any equity securities that were not registered under the Securities Act of 1933, as amended. We announced a stock repurchase plan on November 5, 2007, for the repurchase of up to a total of 5,000,000 shares. This plan replaced all previous share repurchase plans and has no



expiration date. We did not repurchase any shares under this plan during the nine months ended September 30, 2013. At September 30, 2013, 4,005,985 shares remained available for repurchase under our stock repurchase plan.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Not Applicable**

**Item 5. Other Information**

None.

**Table of Contents****Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Exhibit</b>
3.1	Articles of Amendment and Restatement of the Registrant, effective July 6, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1, filed on August 6, 2008)
3.1.1	Articles Supplementary of the Registrant, effective August 10, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.1, filed on August 6, 2008)
3.1.2	Articles Supplementary of the Registrant, effective August 11, 1995 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.2, filed on August 6, 2008)
3.1.3	Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008)
3.1.4	Certificate of Amendment of the Registrant, effective June 30, 1998 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.4, filed on August 6, 2008)
3.1.5	Articles Supplementary of the Registrant, effective April 7, 2003 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.5, filed on August 6, 2008)
3.1.6	Articles of Amendment of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008)
3.1.7	Articles of Amendment of the Registrant, effective May 19, 2009 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009)
3.1.8	Articles of Amendment of the Registrant, effective May 24, 2011 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 20, 2011)
3.1.9	Articles of Amendment of the Registrant, effective May 18, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2012)
3.1.10	Articles of Amendment of the Registrant, effective May 16, 2013 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2013)
3.2.1	Amended and Restated Bylaws of the Registrant, as adopted on March 5, 2008 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008)
3.2.2	First Amendment to Amended and Restated Bylaws of the Registrant, as adopted on May 17, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.2, filed on May 21, 2012)
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	

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Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2013, is filed in XBRL-formatted interactive data files: (i) Consolidated Balance Sheets at September 30, 2013 and December 31, 2012;

(ii) Consolidated Statements of Income for the three and nine months ended September 30, 2013 and 2012;

(iii) Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2013 and 2012;

(iv) Consolidated Statements of Changes in Equity for the nine months ended September 30, 2013 and 2012;

(v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2013 and 2012; and

(vi) Notes to Consolidated Financial Statements.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**REDWOOD TRUST, INC.**

Date: November 7, 2013

By: /s/ MARTIN S. HUGHES  
Martin S. Hughes  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 7, 2013

By: /s/ CHRISTOPHER J. ABATE  
Christopher J. Abate  
Chief Financial Officer  
(Principal Financial Officer)

Date: November 7, 2013

By: /s/ COLLIN L. COCHRANE  
Collin L. Cochrane  
Controller  
(Principal Accounting Officer)

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(vi) Notes to Consolidated Financial Statements.