REDWOOD TRUST INC
Form 10-Q
November 05, 2007

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, 2007

OR

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

For the Transition Period From __________ to __________

Commission File Number 1-13759

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	68-0329422 (I.R.S. Employer Identification No.)

One Belvedere Place, Suite 300
Mill Valley, California 94941

(Address of Principal Executive Offices) (Zip Code)

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(g) of the Act:

Title of Each Class:	Name of Exchange on Which Registered:
Common Stock, par value $0.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

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 o NO x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o NO x

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

Common Stock, $0.01 par value per share	28,072,642 as of November 5, 2007

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REDWOOD TRUST, INC.

2007 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data) (Unaudited)	September 30, 2007	December 31, 2006
ASSETS		
Real estate loans	$ 7,656,035	$ 9,352,107
Real estate securities	2,926,388	3,232,767
Other real estate investments	25,300	
Non-real estate investments	80,000	
Cash and cash equivalents	309,544	168,016
Total earning assets	10,997,267	12,752,890
Restricted cash	137,062	112,167
Accrued interest receivable	50,473	70,769
Derivative assets	19,749	26,827
Deferred tax asset	5,943	5,146
Deferred asset-backed securities issuance costs	46,875	42,468
Other assets	25,439	20,206
Total Assets	$ 11,282,808	$ 13,030,473
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities		
Redwood debt	$ 39,378	$ 1,856,208
Asset-backed securities issued	10,802,528	9,979,224
Accrued interest payable	63,177	50,590
Derivative liabilities	28,477	6,214
Accrued expenses and other liabilities	29,467	16,832
Dividends payable	20,989	18,715
Subordinated notes	150,000	100,000
Total liabilities	11,134,016	12,027,783
Commitments and contingencies (Note 17)		
Stockholders Equity		
Common stock, par value $0.01 per share, 50,000,000 shares authorized; 27,985,954 and 26,733,460 issued and outstanding	280	267
Additional paid-in capital	974,748	903,808
Accumulated other comprehensive income (loss)	(735,082)	93,158
Cumulative earnings	777,819	809,011
Cumulative distributions to stockholders	(868,973)	(803,554)
Total stockholders equity	148,792	1,002,690
Total Liabilities and Stockholders Equity	$ 11,282,808	$ 13,030,473

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 (LOSS)

(In Thousands, Except Share Data) (Unaudited)	Three Months Ended September 30, 2007	2006	Nine Months Ended September 30, 2007	2006
Interest Income				
Real estate loans	$116,670	$149,018	$363,097	$470,893
Real estate securities	94,776	72,759	273,427	189,656
Other real estate investments	1,275		4,409	
Non-real estate investments	1,143		1,607	
Cash and cash equivalents	4,960	1,872	11,048	7,220
Total interest income	218,824	223,649	653,588	667,769
Interest Expense				
Redwood debt	(5,858)	(9,422)	(59,652)	(13,316)
Asset-backed securities issued	(156,222)	(165,251)	(431,709)	(515,531)
Subordinated notes	(3,150)		(7,722)	
Total interest expense	(165,230)	(174,673)	(499,083)	(528,847)
Net Interest Income	53,594	48,976	154,505	138,922
Operating expenses	(11,732)	(13,455)	(42,286)	(42,074)
Realized gains on sales and calls, net	1,824	5,690	5,708	15,740
Market valuation adjustments, net	(102,766)	(5,257)	(142,460)	(11,184)
Net (loss) income before provision for income taxes	(59,080)	35,954	(24,533)	101,404
Provision for income taxes	(1,837)	(3,538)	(6,659)	(9,563)
Net (Loss) Income	$(60,917)	$32,416	$(31,192)	$91,841
Basic earnings (loss) per share:	$(2.18)	$1.25	$(1.14)	$3.60
Diluted earnings (loss) per share:	$(2.18)	$1.22	$(1.14)	$3.51
Regular dividends declared per common share	$0.75	$0.70	$2.25	$2.10
Special dividends declared per common share	$	$	$	$
Total dividends declared per common share	$0.75	$0.70	$2.25	$2.10
Basic weighted average shares outstanding	27,892,199	25,869,743	27,388,185	25,525,054
Diluted weighted average shares outstanding	27,892,199	26,624,532	27,388,185	26,132,000

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 (LOSS)

(In Thousands) (Unaudited)	Three Months Ended September 30, 2007	2006	Nine Months Ended September 30, 2007	2006
Net (Loss) Income	$(60,917)	$32,416	$(31,192)	$91,841
Other Comprehensive (Loss) Income:				
Net unrealized (losses) gains on available-for-sale securities	(644,975)	31,342	(839,405)	29,962
Reclassification adjustment for net losses included in net income	18,908	30	25,853	686
Unrealized (losses) on cash flow hedges, net	(28,285)	(27,576)	(14,471)	(3,261)
Reclassification of net realized cash flow hedge losses (gains) to interest expense on asset-backed securities issued and realized gains on sales	183	47	(217)	(6,338)
Total Other Comprehensive (Loss) Income	(654,169)	3,843	(828,240)	21,049
Comprehensive (Loss) Income	$(715,086)	$36,259	$(859,432)	$112,890

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For Nine Months Ended September 30, 2007

For Nine Months Ended September 30, 2006

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) (Unaudited)	Nine Months Ended September 30, 2007	2006
Cash Flows From Operating Activities:		
Net (loss) income	$(31,192)	$91,841
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs	(48,418)	(48,611)
Depreciation and amortization of non-financial assets	1,334	836
Provision for (reversal of) credit losses	7,836	(1,865)
Non-cash equity award compensation	11,374	11,256
Net recognized losses (gains) and valuation adjustments	136,752	(4,556)
Purchases of other real estate investments trading	(40,818)	
Purchases of non-real estate investments trading	(80,000)	
Principal payments on other real estate investments trading	11,345	
Net change in:		
Accrued interest receivable	20,296	9,165
Deferred income taxes	(716)	212
Other assets	9,052	(80)
Accrued interest payable	12,587	10,277
Accrued expenses and other liabilities	12,635	(10,622)
Net cash provided by operating activities	22,067	57,853
Cash Flows From Investing Activities:		
Purchases of real estate loans held-for-investment	(1,173,029)	(1,291,989)
Proceeds from sales of real estate loans held-for-investment	15,454	8,408
Principal payments on real estate loans held-for-investment	2,797,271	5,303,962
Purchases of real estate securities available-for-sale	(1,173,627)	(818,219)
Proceeds from sales of real estate securities available-for-sale	353,506	241,624
Proceeds from sales of other real estate investments trading	2,237	
Principal payments on real estate securities available-for-sale	256,521	161,790
Net increase in restricted cash	(24,895)	(67,020)
Net cash provided by investing activities	1,053,438	3,538,556
Cash Flows From Financing Activities:		
Net (repayments) borrowings on Redwood debt	(1,816,830)	340,287
Proceeds from issuance of asset-backed securities	4,217,357	1,460,572
Deferred asset-backed security issuance costs	(22,339)	(10,591)
Repayments on asset-backed securities	(3,352,784)	(5,431,649)
Proceeds from issuance of subordinated notes	50,000	
Net purchases of interest rate agreements	(5,814)	(2,186)
Net proceeds from issuance of common stock	59,579	39,236

Dividends paid	(63,146)	(55,037)
Net cash used in financing activities	(933,977)	(3,659,368)
Net increase (decrease) in cash and cash equivalents	141,528	(62,959)
Cash and cash equivalents at beginning of period	168,016	175,885
Cash and cash equivalents at end of period	$309,544	$112,926
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$486,496	$518,570
Cash paid for taxes	$10,580	$7,999
Non-Cash Financing Activity:		
Dividends declared but not paid	$20,989	$18,237

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. Our primary focus is credit-enhancing residential and commercial real estate loans. We credit-enhance loans by acquiring and managing the first-loss and other credit-sensitive securities that bear the bulk of the credit risk of securitized loans.

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

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2007 and December 31, 2006 and for the three and nine months ended September 30, 2007 and 2006. The accompanying consolidated financial statements are unaudited. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and, in our opinion, reflect all adjustments necessary for a fair statement of our financial position, results of operations, and cash flows. These consolidated financial statements and notes thereto should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006. The results for the nine months ended September 30, 2007 are not necessarily indicative of the expected results for the year ended December 31, 2007. Certain amounts for prior years have been reclassified to conform to the September 30, 2007 presentation.

These consolidated financial statements include the accounts of Redwood Trust, Inc. (Redwood Trust) and its direct and indirect wholly-owned subsidiaries (collectively, Redwood). All inter-company balances and transactions have been eliminated in consolidation. A number of Redwood Trust s subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT mean Redwood Trust and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We currently operate two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the Sequoia securitization entities. Our Acacia program involves the resecuritization of mortgage-backed securities and other types of financial assets through the issuance of collateralized debt obligations (CDOs). References to Acacia refer collectively to all of the Acacia CDO issuing entities.

Under the provisions of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), we treat the securitizations we sponsor as financings, as under these provisions we have retained effective control over these loans and securities. Control is maintained through our active management of the assets in the securitization entities, our retained asset transfer discretion, our ability to direct certain servicing decisions, or a combination of the foregoing. Accordingly, the underlying loans and securities owned by these securitization entities are shown on our consolidated balance sheets under real estate loans, real estate securities, and the asset-back securities (ABS) issued to third parties are shown on our consolidated balance sheets under ABS issued. In our consolidated statements of income (loss), we record interest income on the loans and securities and interest expense on the ABS issued. Any Sequoia ABS acquired by Redwood or Acacia from Sequoia entities and any Acacia ABS acquired by Redwood for its own portfolio are eliminated in consolidation and thus are not

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 2. Summary of Significant Accounting Policies (continued)

shown separately on our consolidated balance sheets and the associated income and expense are not shown separately on our consolidated statements of income (loss).

Use of Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States of America (GAAP) requires us to make a significant number of estimates. These include fair market value of certain assets, amount and timing of credit losses, prepayment assumptions, and other items 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., market values due to changes in supply and demand, credit performance, prepayments, interest rates, or other reasons; yields due to changes in credit outlook and loan prepayments) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences may be material.

Real Estate Loans

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

Real estate loans include residential and commercial real estate loans. Real estate loans held-for-investment are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for credit losses.

Coupon interest is recognized as revenue when earned and deemed collectible. We accrue interest on loans until they are more than 90 days past due at which point they are placed on nonaccrual status. Purchase discounts and premiums related to real estate loans are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the loans pursuant to the provisions discussed below. Gains or losses on the sale of real estate loans are based on the specific identification method.

Pursuant to Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (FAS 91), we use the interest method to determine an effective yield and amortize the premium or discount on loans. For loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

We may exercise our right to call ABS issued by entities sponsored by us and may subsequently sell the underlying loans to third parties. For balance sheet purposes, we reclassify held-for-investment loans to held-for-sale loans once we determine which loans will be sold to third parties. In our consolidated statements of cash flows, sales of loans are reported as sales of loans held-for-investment as the acquisition of loans were reported as purchases of loans held-for-investment.

Residential and Commercial Real Estate Loans: Held-for-Sale

Residential and commercial real estate loans that we are marketing for sale are classified as real estate loans held-for-sale. These are carried at the lower of cost or fair market value on a loan-by-loan basis. Any market valuation adjustments on these loans are recognized in valuation adjustments, net in our consolidated statements of income (loss).

Real Estate Loans Reserve for Credit Losses

For consolidated real estate loans held-for-investment, we establish and maintain credit reserves based on estimates of credit losses inherent in these loan portfolios as of the reporting date. To calculate the credit

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Note 2. Summary of Significant Accounting Policies (continued)

reserve, we assess inherent losses by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each of the consolidated loans, loan pools, or individual loans. See *Note 8* for a discussion of the reserves for credit losses.

We follow the guidelines of Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation* (SAB 102), Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), and Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures* (FAS 118) in setting credit reserves for our real estate loans.

The following factors are considered and applied in such determinations:

Ongoing analyses of loans, including, but not limited to, the age of loans, underwriting standards, business climate, economic conditions, geographical considerations, and other observable data;
Historical loss rates and past performance of similar loans;
Relevant environmental factors;
Relevant market research and publicly available third-party reference loss rates;
Trends in delinquencies and charge-offs;
Effects and changes in credit concentrations;
Information supporting the borrowers ability to meet obligations;
Ongoing evaluations of fair market values of collateral using current appraisals and other valuations; and
Discounted cash flow analyses.

Once we determine applicable default amounts, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an effective loss confirmation period. This period is defined as the range of time between the probable 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 credit reserves because we believe those losses exist as of the reported date of the financial statements. We re-evaluate the level of our credit reserves on at least a quarterly basis, and we record provision, charge-offs, and recoveries monthly.

We do not maintain a loan repurchase reserve, as any risk of loss due to loan repurchases (i.e., due to breach of representations) would normally be covered by recourse to the companies from whom we acquired the loans.

Real Estate Securities

Real estate securities include residential, commercial, and CDO securities. Real estate securities are classified as available-for-sale (AFS) and are carried at their estimated fair market values. Cumulative unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss) in our consolidated statements of stockholders equity. Upon sale this accumulated other comprehensive income (loss) is reclassified into earnings on the specific identification method.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 2. Summary of Significant Accounting Policies (continued)

Coupon interest is recognized as revenue when earned and deemed collectible. Purchase discounts and premiums related to the securities are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the securities pursuant to the provisions discussed below. Gains or losses on the sale of securities are based on the specific identification method.

When recognizing revenue on AFS securities, we employ the interest method to account for purchase premiums, discounts, and fees associated with these securities. For securities rated AAA or AA, we use the interest method as prescribed under FAS 91, while for securities rated A or lower we use the interest method as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). The use of these methods requires us to project cash flows over the remaining life of each asset. These projections include assumptions about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review and make adjustments to 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. Actual maturities of AFS securities are generally shorter than stated contractual maturities. All of our stated maturities are greater than ten years. Actual maturities of the AFS securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal. There can be no assurance that our assumptions used to estimate future cash flows or the current period s yield for each asset would not change in the near term, and the change could be material.

Yields recognized for GAAP for each security vary as a function of credit results, prepayment rates, and, for our securities with variable rate coupons, 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), 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), the yield over the remaining life of the security may be adjusted downward or we may have an other-than-temporary impairment.

For determining other-than-temporary impairment on our real estate securities, we use the guidelines prescribed under EITF 99-20, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), and Staff Accounting Bulletin No. 5(m), *Other-Than-Temporary Impairment for Certain Investments in Debt and Equity Securities* (SAB 5(m)). Any other-than-temporary impairments are reported under market valuation adjustments, net in our consolidated statements of income (loss). For real estate securities subject to EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1), we assess whether a drop in fair market value below the cost of the real estate security should be deemed as other-than-temporary impairment. If we have the ability and intent to hold a real estate security for a reasonable period of time sufficient for a forecasted recovery of fair market value up to (or beyond) the cost of the investment, we do not deem that unrealized loss an other-than-temporary impairment.

In the footnotes to the consolidated financial statements, we disclose information on our real estate securities portfolio based on the underlying residential, commercial, and CDO assets. We also provide a further breakdown of these securities by investment-grade securities (IGS, those rated BBB to AAA) and credit-enhancement securities (CES, those rated non-rated to BB, also referred to as first-loss, second-loss, and third-loss securities) based on their current credit rating as of the consolidated balance sheet.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 2. Summary of Significant Accounting Policies (continued)

Other Real Estate Investments

Other real estate investments include interest-only certificates (IOs), net interest margin securities (NIMs), and residual securities (residuals). At the conclusion of the first quarter of 2007, we classified these investments as trading securities. With the adoption of *Statement of Financial Accounting Standards* No. 155, *Accounting for Certain Hybrid Financial Investments,* (FAS 155), IOs, NIMs, and residuals may contain embedded derivatives which would require bifurcation and separate valuation through the income statement. We have elected to treat these investments as trading securities under FAS 115 rather than bifurcate the embedded derivative component. Trading securities are reported on our consolidated balance sheet at their estimated fair market values with changes in fair market values reported through our consolidated statements of income (loss) through market valuation adjustments.

Total income recognized in current period earnings on these investments equals coupon interest earned plus the change in fair market value. Interest income is equal to the instruments yield based on market expectations.

Non-Real Estate Investments

Non-real estate investments represents a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial statements purposes. We have classified this investment as a trading security that is recorded on our consolidated balance sheets at its estimated fair market value. Management considers the GIC s fair market value to approximate contract value, as the interest rate is variable at LIBOR minus a spread and resets on a monthly basis. Changes in fair market value are reported through our consolidated statements of income (loss) through market valuation adjustments. See *Note 6* for further discussion of our non-real estate investments.

Cash and Cash Equivalents

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

Derivative Financial Instruments

All derivative financial instruments are reported at fair market value on our consolidated balance sheets. Those with a positive value to us are reported as an asset and those with a negative value to us are reported as a liability. Whether changes in the fair market value of these instruments are reported through our income statement depends on the type of derivative and the accounting treatment chosen.

We currently enter into interest rate agreements to help manage some of our interest rate risks. We report our interest rate agreements at fair market value. We may elect hedge accounting treatment under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), or we may account for these as trading instruments. Net purchases and proceeds from interest rate agreements are classified within cash flows as financing activities within the consolidated statement of cash flows together with the items the interest rate agreements hedge.

We designate an interest rate agreement as (1) a hedge of the fair market value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) 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), or (3) held for trading (trading instrument).

In a cash flow hedge, the effective portion of the change in the fair market value of the hedging derivative is recorded in accumulated other comprehensive income (loss) and is subsequently reclassified into earnings when the hedging relationship is terminated. The ineffective portion of the cash flow hedge is

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 2. Summary of Significant Accounting Policies (continued)

recognized immediately in earnings. We use the dollar-offset method to determine the amount of ineffectiveness, and we anticipate having some ineffectiveness in our hedging program, as not all terms of our hedges and not all terms of our hedged items match perfectly.

We will discontinue hedge accounting when (1) we determine that the derivative is no longer expected to be effective in offsetting changes in the fair market value or cash flows of the designated hedged item; (2) the derivative expires or is sold, terminated, or exercised; (3) the derivative is de-designated as a fair value or cash flow hedge; or (4) it is probable that the forecasted transaction will not occur by the end of the originally specified time period.

As of each period end, we may also have outstanding commitments to purchase real estate loans. These commitments are accounted for as derivatives under Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149), when applicable. These are classified as trading instruments and changes in fair market value of the purchase commitments are recorded through valuation adjustments in the consolidated statements of income (loss).

Beginning in the first quarter of 2007, we entered into credit default swap agreements. A credit default swap is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed rate fee or premium over the term of the contract. Under FAS 133, credit default swaps are accounted for as trading instruments.

See *Note 7* for a further discussion of our derivative financial instruments.

Restricted Cash

Restricted cash includes principal and interest payments from real estate loans and securities owned by consolidated securitization entities that are collateral for, or payable to, owners of ABS issued by those entities and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization trusts prior to purchase of real estate loans and securities or the redemption of outstanding ABS issued.

Accrued Interest Receivable

Accrued interest receivable represents interest that is due and payable to us. This is generally received within the next month.

Deferred Tax Assets

Income recognition for GAAP and tax differ in material respects. As a result, we may recognize taxable income in periods prior to recognizing the income for GAAP. When this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. When the income is then realized under GAAP in future periods, the deferred tax asset is recognized as an expense. Our deferred tax assets are generated by differences in GAAP and tax income at our taxable subsidiaries.

Deferred Asset-Backed Securities Issuance Costs

ABS issuance costs are costs associated with the issuance of ABS from securitization entities we sponsor. These costs typically include underwriting, rating agency, legal, accounting, and other fees. Deferred ABS issuance costs are reported on our consolidated balance sheets as deferred charges and are amortized as an adjustment to consolidated interest expense using the interest method based on the actual and estimated repayment schedules of the related ABS issued under the principles prescribed in Accounting Practice Bulletin 21, *Interest on Receivables and Payables* (APB 21).

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 2. Summary of Significant Accounting Policies (continued)

Other Assets

Other assets on our consolidated balance sheets include real estate owned (REO), fixed assets, purchased interest, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair market value.

Redwood Debt

Redwood debt is currently all short-term debt collateralized by loans and securities. We report this debt at its unpaid principal balance.

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote securitization entities sponsored by Redwood. These ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium. Our exposure to loss from consolidated securitization entities (such as Sequoia and Acacia) is limited (except, in some circumstances, for limited loan repurchase obligations) to our net investment in securities we have acquired from these entities. Sequoia and Acacia assets are held in the custody of trustees. Trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the ABS investors. ABS obligations are payable solely from the assets of these entities and are non-recourse to Redwood.

Subordinated Notes

Subordinated notes includes trust preferred securities and subordinated notes. Both are unsecured debt, requiring quarterly interest payments at a floating rate equal to LIBOR plus a spread until they are redeemed in whole, or mature at a future date. These notes contain an earlier optional redemption date without penalty.

Earnings (Loss) per Share

Basic earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares outstanding are calculated using the treasury stock method, which assumes that all dilutive common stock equivalents are exercised and the funds generated by the exercises are used to buy back outstanding common stock at the average market price of the common stock during the reporting period. In accordance with Statement of Financial Accounting Standards No. 128, *Earnings per Share* (FAS 128), if there is a loss from continuing operations, the common stock equivalents are deemed antidilutive and diluted earnings (loss) per share is calculated in the same manner as basic earnings (loss) per share.

The following table provides reconciliation of denominators of the basic and diluted earnings (loss) per share computations.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 2. Summary of Significant Accounting Policies (continued)

Basic and Diluted Earnings (Loss) per Share

(In Thousands, Except Share Data)	Three Months Ended September 30, 2007	2006	Nine Months Ended September 30, 2007	2006
Denominators:				
Denominator for basic earnings (loss) per share is equal to the weighted average number of common shares outstanding during the period	27,892,199	25,869,743	27,388,185	25,525,054
Adjustments for diluted earnings (loss) per share are:				
Net effect of dilutive stock options		754,789		606,946
Denominator for diluted earnings (loss) per share	27,892,199	26,624,532	27,388,185	26,132,000
Basic Earnings (Loss) Per Share:	$(2.18)	$1.25	$(1.14)	$3.60
Diluted Earnings (Loss) Per Share:	$(2.18)	$1.22	$(1.14)	$3.51

Pursuant to EITF 03-6, *Participating Securities and the Two Class Method under FASB No. 128* (EITF 03-6), we determined that there was no allocation of income for our outstanding stock options as they were antidilutive for the three and nine months ended September 30, 2007 and 2006. There were no other participating securities, as defined by EITF 03-6, during the three and nine months ended September 30, 2007 and 2006. For the three months ended September 30, 2007 and 2006, the number of outstanding stock options that were antidilutive totaled 1,159,298 and 369,343 respectively. For the nine months ended September 30, 2007 and 2006, the number of outstanding stock options that were antidilutive totaled 1,186,999, and 384,399 respectively.

Other Comprehensive Income (Loss)

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

Stock-Based Compensation

As of September 30, 2007 and December 31, 2006, we had one stock-based employee compensation plan and one employee stock purchase plan. These plans, and associated stock options and other equity awards, are described more fully in *Note 16*.

We adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (FAS 123R), on January 1, 2006. With the adoption of FAS 123R, the grant date fair market value of all remaining unvested stock compensation awards (stock options, deferred stock units, and restricted stock) are expensed on the consolidated statements of income (loss) over the remaining vesting period.

The Black-Scholes option-pricing model was used in determining fair market values of option grants accounted for under FAS 123R. The model requires the use of inputs such as strike price, and assumptions such as expected life, risk free rate of return, and stock price volatility. Options are generally granted over the course of the calendar year. The stock price volatility assumption is based on the historical volatility of our common stock. Certain options have dividend equivalent rights (DERs) and, accordingly, the assumed dividend yield was zero for these options. Other options granted have no DERs and the assumed dividend yield was 10%.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 2. Summary of Significant Accounting Policies (continued)

The following table describes the weighted average of assumptions used for calculating the value of options granted for the nine months ended September 30, 2007 and 2006. There were no options granted during the three months ended September 30, 2007 and 2006.

Weighted Average Assumptions used for Valuation of Options under FAS 123R Granted during period

	Nine Months Ended September 30,			
	2007		2006	
Stock price volatility	25.52	%	25.70	%
Risk free rate of return (5 yr Treasury Rate)	4.58	%	4.75	%
Average life	6 years		5 years	
Dividend yield	10.00	%	10.00	%

Note 3. Real Estate Loans

We acquire residential real estate loans from third party originators. A portion of these loans are sold to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS. The remainder of the loans we invest in are held and financed with Redwood debt and equity. At September 30, 2007, we had $6.6 million (of outstanding principal) of residential loans in held-for-sale, with a lower of cost or fair market value of $6.0 million, (carrying value) as we are actively marketing these loans for sale.

The following tables summarize the carrying value of the residential and commercial real estate loans, as reported on our consolidated balance sheets at September 30, 2007 and December 31, 2006.

Real Estate Loans Composition

(In Thousands)	September 30, 2007	December 31, 2006

Residential real estate loans held-for-sale	$ 6,048	$
Residential real estate loans held-for-investment	7,624,222	9,323,935
Total residential real estate loans	7,630,270	9,323,935
Commercial real estate loans held-for-investment	25,765	28,172
Total real estate loans	$ 7,656,035	$ 9,352,107

Real Estate Loans Carrying Value Held-for-Investment

September 30, 2007 (In Thousands)	Residential Real Estate Loans	Commercial Real Estate Loans	Total
Current face	$ 7,546,529	$ 38,224	$ 7,584,753
Unamortized premium (discount)	92,888	(1,970)	90,918
Discount designated as credit reserve		(8,141)	(8,141)
Amortized cost	7,639,417	28,113	7,667,530
Reserve for credit losses	(15,195)	(2,348)	(17,543)
Carrying value	$ 7,624,222	$ 25,765	$ 7,649,987

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 3. Real Estate Loans (continued)

December 31, 2006 (In Thousands)	Residential Real Estate Loans	Commercial Real Estate Loans	Total
Current face	$ 9,212,002	$ 38,360	$ 9,250,362
Unamortized premium (discount)	132,052	(2,047)	130,005
Discount designated as credit reserve		(8,141)	(8,141)
Amortized cost	9,344,054	28,172	9,372,226
Reserve for credit losses	(20,119)		(20,119)
Carrying value	$ 9,323,935	$ 28,172	$ 9,352,107

Of the $7.5 billion of face and $92.9 million of unamortized premium on our residential real estate loans at September 30, 2007, $2.7 billion of face and $70.4 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. At December 31, 2006, the residential loans acquired prior to July 1, 2004 had face and unamortized premium balances of $5.2 billion and $104.3 million, respectively. For these residential loans, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. During the first nine months of 2007, 46% of these residential loans prepaid and we amortized 32% of the premium. For residential loans acquired after July 1, 2004, the face and unamortized premium was $4.8

billion and $22.5 million at September 30, 2007, respectively, and $4.0 billion and $27.7 million at December 31, 2006, respectively. For these residential loans, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

Residential real estate loans are either sold to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS or are held and financed with Redwood debt.

The table below presents information regarding real estate loans pledged and unpledged under our borrowing agreements.

Real Estate Loans Pledged and Unpledged

	September 30, 2007		December 31, 2006	
(In Thousands)	Face Value	Carrying Value	Face Value	Carrying Value
Unpledged	$17,772	$6,340	$120,578	$111,231
Pledged for Redwood debt:				
Repurchase (repo) agreements			978,713	982,629
Commercial paper			301,827	302,615
Owned by securitization entities, financed through the issuance of ABS	7,573,608	7,649,695	7,849,244	7,955,632
Total	$7,591,380	$7,656,035	$9,250,362	$9,352,107

Unpledged real estate loans at September 30, 2007 consist mainly of all our held-for-sale residential loans and one commercial loan with a face value of $10.6 million and a carrying value of zero.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 4. Real Estate Securities

The real estate securities shown on our consolidated balance sheets include residential, commercial, and CDO securities acquired from securitizations sponsored by others.

The table below presents the carrying value (which equals fair market value as these are available-for-sale securities (AFS)) of our securities that are included in our consolidated balance sheets as of September 30, 2007 and December 31, 2006, by type of securities, and by credit rating of investment-grade (IGS) and below investment-grade (CES).

Securities (AFS) Underlying Collateral Characteristics

September 30, 2007 (In Thousands)	CES	IGS	Total AFS Securities
Residential securities:			
Prime	$ 408,632	$ 673,467	$ 1,082,099
Alt-a	110,830	703,739	814,569
Subprime	12,983	325,027	338,010
Total residential securities	532,445	1,702,233	2,234,678
Commercial securities	395,401	104,396	499,797
CDO securities	16,758	175,155	191,913
Total securities	$ 944,604	$ 1,981,784	$ 2,926,388

December 31, 2006 (In Thousands)	CES	IGS	Total AFS Securities
Residential securities:			
Prime	$ 555,369	$ 723,247	$ 1,278,616
Alt-a	156,859	455,550	612,409
Subprime	9,303	518,453	527,756
Total residential securities	721,531	1,697,250	2,418,781
Commercial securities	448,060	119,613	567,673
CDO securities	21,964	224,349	246,313
Total securities	$ 1,191,555	$ 2,041,212	$ 3,232,767

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 4. Real Estate Securities (continued)

The table below presents the components comprising the carrying value of available-for-sale IGS reported on our consolidated balance sheets at September 30, 2007 and December 31, 2006.

Investment-Grade Securities (AFS)

September 30, 2007 (In Thousands)	Residential	Commercial	CDO	Total IGS

Current face	$ 2,186,258	$ 120,097	$ 258,183	$ 2,564,538
Unamortized discount, net	(40,139)	(3,054)	1,264	(41,929)
Discount designated as credit reserve	(42,806)		(14,966)	(57,772)
Amortized cost	2,103,313	117,043	244,481	2,464,837
Gross unrealized gains	3,745	113	40	3,898
Gross unrealized losses	(404,825)	(12,760)	(69,366)	(486,951)
Carrying value	$ 1,702,233	$ 104,396	$ 175,155	$ 1,981,784

December 31, 2006 (In Thousands)	Residential	Commercial	CDO	Total IGS
Current face	$ 1,708,607	$ 122,869	$ 222,413	$ 2,053,889
Unamortized discount, net	(16,382)	(3,367)	(238)	(19,987)
Amortized cost	1,692,225	119,502	222,175	2,033,902
Gross unrealized gains	14,622	980	2,638	18,240
Gross unrealized losses	(9,597)	(869)	(464)	(10,930)
Carrying value	$ 1,697,250	$ 119,613	$ 224,349	$ 2,041,212

The following table presents the aggregate changes in our amortized discount and the portion of the discount designated as credit reserve for the three and nine months ended September 30, 2007. We did not have any designated credit reserves on any securities in this portfolio prior to this quarter.

Changes In Unamortized Discount and Designated Credit Reserves on Residential, Commercial, and CDO IGS

Three Months Ended September 30, 2007 (In Thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$ 32,187	$ 3,103	$ 7,096	$ 42,386
Amortization of discount	(1,900)	(60)	(60)	(2,020)
Calls, sales, and other	(677)		1	(676)
Re-designation between credit reserve and discount	4,280		(6,217)	(1,937)
Downgrades to credit-enhancement securities	(1,913)		(2,084)	(3,997)
Purchased discount	8,162	11		8,173
Ending balance of unamortized discount, net	$ 40,139	$ 3,054	$ (1,264)	$ 41,929
Beginning balance of designated credit reserve	$	$	$	$
Realized credit losses				
Calls, sales, and other				
Impairments on AFS securities	47,086		8,749	55,835
Re-designation between credit reserve and discount	(4,280)		6,217	1,937
Purchased discount designated as credit reserve				
Ending balance of designated credit reserve	$ 42,806	$	$ 14,966	$ 57,772

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

September 30, 2007
(Unaudited)

Note 4. Real Estate Securities (continued)

Nine Months Ended September 30, 2007 (In Thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$ 16,382	$ 3,367	$ 238	$ 19,987
Amortization of discount	(5,670)	(196)	(123)	(5,989)
Calls, sales, and other	(5,704)	(4)	116	(5,592)
Re-designation between credit reserve and discount	8,518			8,518
Downgrades to credit-enhancement securities	(1,913)	(160)	(2,199)	(4,272)
Purchased discount	28,526	47	704	29,277
Ending balance of unamortized discount, net	$ 40,139	$ 3,054	$ (1,264)	$ 41,929
Beginning balance of designated credit reserve	$	$	$	$
Realized credit losses				
Calls, sales, and other				
Impairments on AFS securities	51,324		14,966	66,290
Re-designation between credit reserve and discount	(8,518)			(8,518)
Purchased discount designated as credit reserve				
Ending balance of designated credit reserve	$ 42,806	$	$ 14,966	$ 57,772

The table below presents the components comprising the carrying value of available-for-sale CES reported on our consolidated balance sheets at September 30, 2007 and December 31, 2006.

Credit-Enhancement Securities (AFS)

September 30, 2007 (In Thousands)	Residential	Commercial	CDO	Total CES
Current face	$ 1,269,576	$ 880,715	$ 36,440	$ 2,186,731
Unamortized discount, net	(127,079)	(95,968)	(9,855)	(232,902)
Discount designated as credit reserve	(450,839)	(310,498)	(3,827)	(765,164)
Amortized cost	691,658	474,249	22,758	1,188,665
Gross unrealized gains	34,749	8,503	984	44,236
Gross unrealized losses	(193,962)	(87,351)	(6,984)	(288,297)
Carrying value	$ 532,445	$ 395,401	$ 16,758	$ 944,604

December 31, 2006 (In Thousands)	Residential	Commercial	CDO	Total CES
Current face	$ 1,180,605	$ 793,743	$ 28,731	$ 2,003,079
Unamortized discount, net	(144,842)	(71,424)	(6,889)	(223,155)
Discount designated as credit reserve	(372,247)	(295,340)		(667,587)
Amortized cost	663,516	426,979	21,842	1,112,337
Gross unrealized gains	71,134	23,235	516	94,885
Gross unrealized losses	(13,119)	(2,154)	(394)	(15,667)
Carrying value	$ 721,531	$ 448,060	$ 21,964	$ 1,191,555

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 4. Real Estate Securities (continued)

At September 30, 2007, our residential CES provided credit-enhancement on $212 billion of residential real estate loans and our commercial CES provided credit-enhancement on $65 billion of commercial real estate loans. At December 31, 2006, our residential CES provided credit-enhancement on $210 billion of residential real estate loans and our commercial CES provided credit-enhancement on $58 billion of commercial real estate loans.

The loans underlying all of our residential CES totaled $212 billion at September 30, 2007, and consist of $186 billion prime, $21 billion alt-a, and $5 billion subprime. These loans are located nationwide with a large concentration in California (46%). During the first three quarters of 2007, net realized residential credit losses were $15.6 million of principal value, a rate that equals one basis point (0.01%) on an annualized basis of the balance of the loans. Serious delinquencies (90+ days, in foreclosure, in bankruptcy or REO) at September 30, 2007 were 1.03% of current balance and 0.57% of original balance. For loans in prime pools, delinquencies were 0.45% of current balance and 0.25% of original balance. Alt-a pools had delinquencies of 3.10% of current balance and 1.60% of original balance. Subprime pools had delinquencies of 13.76% of current balance and 10.00% of original balance.

The amount of designated credit reserve equals the estimate of credit losses within the underlying loan pool on the CES that we expect to incur over the life of the loans. This estimate is determined based upon various factors affecting these assets, including economic conditions, characteristics of the underlying loans, delinquency status, past performance of similar loans, and external credit reserves. We use a variety of internal and external credit risk cash flow modeling and portfolio analytical tools to assist in our assessments. We review our assessments on each individual underlying loan pool and determine the appropriate level of credit reserve required for each security we own at least quarterly. The designated credit reserve is specific to each security.

The following table presents the aggregate changes in our unamortized discount and the portion of the discount designated as credit reserve for the three and nine months ended September 30, 2007 and 2006.

Changes In Unamortized Discount and Designated Credit Reserves on Residential, Commercial, and CDO CES

Three Months Ended September 30, 2007 (In Thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$ 125,948	$ 95,346	$ 9,955	$ 231,249
Amortization of discount	(18,431)	(65)		(18,496)

Calls, sales, and other	(1,996)		(2,184)	(4,180)
Re-designation between credit reserve and discount	17,972	687		18,659
Downgrades from investment-grade securities	1,913		2,084	3,997
Purchased discount	1,673			1,673
Ending balance of unamortized discount, net	$ 127,079	$ 95,968	$ 9,855	$ 232,902
Beginning balance of designated credit reserve	$ 453,076	$ 310,745	$	$ 763,821
Realized credit losses	(6,143)	(272)		(6,415)
Calls, sales, and other	(1,209)			(1,209)
Impairments on AFS securities	22,521	712	3,827	27,060
Re-designation between credit reserve and discount	(17,972)	(687)		(18,659)
Purchased discount designated as credit reserve	566			566
Ending balance of designated credit reserve	$ 450,839	$ 310,498	$ 3,827	$ 765,164

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
September 30, 2007
(Unaudited)

Note 4. Real Estate Securities (continued)

Three Months Ended September 30, 2006 (In Thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$ 116,702	$ 28,184	$ 7,978	$ 152,864
Amortization of discount	(15,901)	448		(15,453)
Calls, sales, and other	(2,981)	(3,871)	(593)	(7,445)
Re-designation between credit reserve and discount	31,534	1,271		32,805
Downgrades from investment-grade securities				
Purchased discount	9,809	22,217		32,026
Ending balance of unamortized discount, net	$ 139,163	$ 48,249	$ 7,385	$ 194,797
Beginning balance of designated credit reserve	$ 425,578	$ 192,134	$	$ 617,712
Realized credit losses	(2,004)	(472)		(2,476)
Calls, sales, and other	(36,355)			(36,355)
Re-designation between credit reserve and discount	(31,534)	(1,271)		(32,805)
Purchased discount designated as credit reserve	28,711	67,991		96,702
Ending balance of designated credit reserve	$ 384,396	$ 258,382	$	$ 642,778

Changes In Unamortized Discount and Designated Credit Reserves on Residential, Commercial, and CDO CES

Nine Months Ended September 30, 2007	Residential	Commercial	CDO	Total

(In Thousands)				
Beginning balance of unamortized discount, net	$ 144,842	$ 71,424	$ 6,889	$ 223,155
Amortization of discount	(58,388)	(256)		(58,644)
Calls, sales, and other	521	(42)	(2,079)	(1,600)
Re-designation between credit reserve and discount	31,265	10,975		42,240
Downgrades from investment-grade securities	1,913	160	2,199	4,272
Purchased discount	6,926	13,707	2,846	23,479
Ending balance of unamortized discount, net	$ 127,079	$ 95,968	$ 9,855	$ 232,902
Beginning balance of designated credit reserve	$ 372,247	$ 295,340	$	$ 667,587
Realized credit losses	(15,596)	(1,543)		(17,139)
Calls, sales, and other	(4,883)			(4,883)
Impairments on AFS securities	35,305	1,520	3,827	40,652
Re-designation between credit reserve and discount	(31,265)	(10,975)		(42,240)
Purchased discount designated as credit reserve	95,031	26,156		121,187
Ending balance of designated credit reserve	$ 450,839	$ 310,498	$ 3,827	$ 765,164

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NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 4. Real Estate Securities (continued)

Nine Months Ended September 30, 2006 (In Thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$ 121,824	$ 28,993	$ 8,004	$ 158,821
Amortization of discount	(39,977)	1,269	44	(38,664)
Calls, sales, and other	(3,036)	(2,663)	(663)	(6,362)
Re-designation between credit reserve and discount	54,184	(4,042)		50,142
Upgrades to investment-grade securities	(6,249)			(6,249)
Purchased discount	12,417	24,692		37,109
Ending balance of unamortized discount, net	$ 139,163	$ 48,249	$ 7,385	$ 194,797
Beginning balance of designated credit reserve	$ 354,610	$ 141,806	$	$ 496,416
Realized credit losses	(5,623)	(336)		(5,959)
Calls, sales, and other	(41,258)			(41,258)
Re-designation between credit reserve and discount	(54,185)	4,042		(50,143)
Purchased discount designated as credit reserve	130,852	112,870		243,722
Ending balance of designated credit reserve	$ 384,396	$ 258,382	$	$ 642,778

For the three and nine months ended September 30, 2007, we recognized other-than-temporary impairments of $82.9 million and $104.5 million, respectively, through market valuation adjustments in our consolidated statements of income (loss). For the three and nine months ended September 30, 2006, we recognized other-than-temporary impairments of $0.5 million and $6.0 million, respectively.

The table below presents the gross realized gains and losses on securities and the realized gains on calls for the three and nine months ended September 30, 2007 and 2006.

Gross Realized Gains and Losses on Real Estate Securities

(In Thousands)	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Gross realized gains on sales of securities	$ 3,221	$ 5,590	$ 6,636	$ 10,040
Gross realized losses on sales of securities	(3,050)	(623)	(5,787)	(1,973)
Gains on calls of securities	3,284	723	5,437	1,470
Total realized gains on sales and calls	$ 3,455	$ 5,690	$ 6,286	$ 9,537

Gross unrealized gains and losses represent the difference between the net amortized cost and the fair market value of individual securities. Gross unrealized losses represent a decline in fair market value for securities not deemed impaired under GAAP.

The following tables show the gross unrealized losses, fair market values, and length of time that any real estate securities have been in a continuous unrealized loss position as of September 30, 2007 and December 31, 2006. These unrealized losses are not considered to be other-than-temporary impairments because these losses are not due to adverse changes in cash flows and we have the intent and ability to hold these securities for a period sufficient for these securities to potentially recover their values.

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NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 4. Real Estate Securities (continued)

Securities with Unrealized Losses

September 30, 2007 (In Thousands)	Less Than 12 Months Fair MarketValue	Less Than 12 Months Unrealized Losses	12 Months or More Fair Market Value	12 Months or More Unrealized Losses	Total Fair Market Value	Total Unrealized Losses
Residential	$ 1,627,431	$ (539,169)	$ 304,429	$ (59,618)	$ 1,931,860	$ (598,787)

Commercial	354,456	(85,120)	81,716	(14,991)	436,172	(100,111)
CDO	166,405	(68,990)	10,766	(7,360)	177,171	(76,350)
Total securities	$ 2,148,292	$ (693,279)	$ 396,911	$ (81,969)	$ 2,545,203	$ (775,248)

December 31, 2006 (In Thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Market Value	Unrealized Losses	Fair Market Value	Unrealized Losses	Fair Market Value	Unrealized Losses
Residential	$ 495,242	$ (9,938)	$ 385,170	$ (12,778)	$ 880,412	$ (22,716)
Commercial	111,603	(1,055)	85,010	(1,968)	196,613	(3,023)
CDO	29,378	(257)	29,543	(601)	58,921	(858)
Total securities	$ 636,223	$ (11,250)	$ 499,723	$ (15,347)	$ 1,135,946	$ (26,597)

We fund the credit-sensitive securities we acquire with equity. We fund some of the securities we acquire on a temporary basis with short-term borrowings prior to the sale to the securitization entities we sponsor. We also acquire less credit-risk sensitive assets and finance these investments with a combination of Redwood debt and equity.

The table below presents information regarding our securities pledged under borrowing agreements and owned by securitization entities as of September 30, 2007 and December 31, 2006.

Securities Pledged and Unpledged

(In Thousands)	September 30, 2007	December 31, 2006
Unpledged	$ 361,274	$ 463,891
Pledged for Redwood debt	44,215	593,070
Owned by securitization entities, financed through issuance of ABS	2,520,899	2,175,806
Carrying value	$ 2,926,388	$ 3,232,767

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 5. Other Real Estate Investments

Other real estate investments shown on our consolidated balance sheets include IOs, NIMs, and residuals. We have elected to classify these investments as trading investments under GAAP. These assets are carried at fair market value on our consolidated balance sheet and changes in fair market value flow through market valuation adjustments, net on our consolidated statements of income (loss).

The table below presents the carrying value (which equals fair market value as these are classified as trading instruments) of these investments as of September 30, 2007. We did not have any assets classified as other real estate investments at December 31, 2006.

Other Real Estate Investments   Trading

September 30, 2007 (In Thousands)	Prime	Alt-a	Subprime	Total
Residential				
IOs	$ 1,676	$ 285	$	$ 1,961
NIMs		9,170	6,450	15,620
Residuals		6,848	871	7,719
Total other real estate investments	$ 1,676	$ 16,303	$ 7,321	$ 25,300

The fair market value of our other real estate investments declined $2.8 million and $14.4 million for the three and nine months ended September 30, 2007, respectively. As of September 30, 2007, $1.2 million of other real estate investments were owned by securitization entities and financed through the issuance of ABS and the remaining $24.1 million were funded with equity.

Note 6. Non-Real Estate Investments

Non-real estate investments represents an $80 million guaranteed investment contract (GIC) entered into during the second quarter of 2007 by an Acacia securitization entity that we consolidate for financial statements purposes.

This GIC represents a deposit certificate issued by a rated investment bank. This GIC serves as the collateral to cover potential losses on a credit default swap (CDS) also entered into by this same Acacia entity. The CDS references BBB and A rated residential mortgage-backed securities issued in 2006. In the event that any of these referenced securities incurs a credit loss, the GIC can then be drawn upon by the CDS counterparty to cover the amount of such loss. We have classified this investment as a trading security that is recorded on our consolidated balance sheets at its estimated fair market value. Management currently considers the GIC s fair market value to approximate contract value, as the interest rate is variable at LIBOR less 5 basis points and resets on a monthly basis. Changes in fair market value are reported through our consolidated statements of income (loss) through market valuation adjustments.

The carrying and fair market value was $80 million of this investment as of September 30, 2007. We did not have any assets classified as non-real estate investments in prior periods.

Note 7. Derivative Financial Instruments

We report our derivative financial instruments at fair market value as determined using third-party models and confirmed by Wall Street dealers. As of September 30, 2007 and December 31, 2006, the net fair market value of derivative financial instruments was negative $8.7 million and positive $20.6 million, respectively.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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(Unaudited)

Note 7. Derivative Financial Instruments (continued)

The following table shows the aggregate fair market value and notional amount of our derivative financial instruments as of September 30, 2007 and December 31, 2006.

	September 30, 2007		December 31, 2006	
(In Thousands)	Fair Market Value	Notional Amount	Fair Market Value	Notional Amount
Trading Instruments				
Interest rate caps purchased	$ 4,463	$ 706,400	$ 1,114	$ 71,900
Interest rate caps sold	(1,168)	250,000		
Interest rate corridors purchased		714,618		844,805
Interest rate swaps	(35)	277,059	242	131,195
Credit default swaps	(19,837)	83,000	(6)	1,000
Futures			90	204,000
Purchase commitments			(168)	80,964
Cash Flow Hedges				
Futures			(44)	627,000
Interest rate swaps	7,849	934,266	19,385	1,279,007
Total Derivative Financial Instruments	$ (8,728)	$ 2,965,343	$ 20,613	$ 3,239,871

Interest Rate Agreements

We maintain an overall interest rate risk management strategy that incorporates the use of interest rate agreements for a variety of reasons, including minimizing significant fluctuations in earnings or market values on certain assets or liabilities that may be caused by interest rate volatility. Currently, the majority of our interest rate agreements are used to match the duration of liabilities to assets. Interest rate agreements we use as part of our interest rate risk management strategy may include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchases. We currently account for our interest rate agreements as either cash flow hedges or trading instruments.

In a cash flow hedge, the effective portion of the change in the fair market value of the hedging derivative is recorded in accumulated other comprehensive income (loss) and is subsequently reclassified into earnings when the hedging relationship is terminated. The ineffective portion of the cash flow hedge is recognized immediately in earnings. For the three and nine months ended September 30, 2007, the amount of ineffectiveness was $42,000 income and $0.6 million income, respectively, and was $0.3 million income and $0.5 million income for the three and nine months ended September 30, 2006, respectively.

We reclassified negative $0.2 million and negative $0.9 million from other comprehensive income (loss) to interest expense for the three and nine months ended September 30, 2007, respectively, and reclassified negative $47,000 and positive $0.4 million for the three and nine months ended September 30, 2006, respectively.

Our interest rate agreements had net receipts of $2.1 million and $7.2 million for the three and nine months ended September 30, 2007, respectively, and net receipts of $3.0 million and $9.1 million for the three and nine months ended September 30, 2006, respectively.

The following table presents the interest income and expense of our interest rate agreements accounted for as cash flow hedges for the three and nine months ended September 30, 2007 and 2006.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 7. Derivative Financial Instruments (continued)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2007	2006	2007	2006
Net interest income on cash flow interest rate agreements	$2,100	$3,042	$7,222	$9,096
Realized net gains due to net ineffective portion of hedges	42	322	631	455
Realized net (losses) gains reclassified from other comprehensive income (loss)	(183)	(47)	(860)	425
Total	$1,959	$3,317	$6,993	$9,976

When the interest rate agreement is accounted for as a trading instrument, changes in the fair market value of the interest rate agreement and all associated income and expenses are reported in earnings through net recognized valuation adjustments. We had net valuation adjustments on interest rate agreements of negative $17.9 million and negative $20.9 million for three and nine months ended September 30, 2007, respectively, and negative $8.5 million and positive $1.0 million for the three and nine months ended September 30, 2006, respectively.

Interest rate agreements accounted for as cash flow hedges may be terminated prior to the completion of the forecasted transactions. In these cases, and when the forecasted transaction is still likely to occur, the net gain or loss on the interest rate agreements remains in accumulated other comprehensive income (loss) and is reclassified from accumulated other comprehensive income (loss) to our consolidated statements of income (loss) during the period the forecasted transaction occurs.

In the case when the hedge is terminated and the forecasted transaction is not expected to occur, we immediately recognize the gain or loss through gains on sales, net in our consolidated statements of income (loss). For the three months ended September 30, 2007, there were no such instances. For the nine months ended September 30, 2007, there was one such instance which resulted in a gain of $1 million. For the nine months ended September 30, 2006, there was one such instance which resulted in a gain of $6 million.

Our total unrealized gain or loss on interest rate agreements included in accumulated other comprehensive income (loss) was negative $8.0 million at September 30, 2007 and positive $6.7 million at December 31, 2006.

Purchase Commitments

Our loan purchase commitments represent derivative instruments under Financial Accounting Standard No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149.) At September 30, 2007, we had no loan purchase commitments. At December 31, 2006, the fair market value of our loan purchase commitments was negative $0.2 million. The change in fair market value from period to period is included in valuation adjustments, in our consolidated statements of income (loss).

Credit Default Swaps

A credit default swap is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed rate fee or premium over the term of the contract. In the first quarter of 2007, we began entering into these agreements where we agreed to provide credit event protection in exchange for a premium. In essence, these instruments enables us to credit enhance a specific pool of loans. We included these credit default swaps in our Acacia CDO Option Arm 1 which closed in the second quarter of 2007.

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NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 7. Derivative Financial Instruments (continued)

Credit default swaps are accounted for as trading instruments, reported at fair market value with the changes in fair market value recognized through our income statement. The value of these contracts decrease for a variety of reasons, including when the probability of the occurrence of a specific credit event increases, when the market s perceptions of default risk in general change, or when there are changes in the supply and demand of these instruments. Since the acquisition of these credit default swaps, the value has decreased $19.3 million, primarily as the result of widening spreads in these types of instruments.

Counterparty Credit Risk

We incur credit risk to the extent that the counterparties to the derivative financial instruments do not perform their obligations under the agreements. If one of the counterparties does not perform, we may not receive the cash to which we would otherwise be entitled under the agreement. In order to mitigate this risk, we only enter into agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the U.S. Department of Treasury as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated BBB or higher. Furthermore, we generally enter into agreements with several different counterparties in order to diversify our credit risk exposure. At September 30, 2007, we had $2.0 million credit exposure on interest rate agreements. At December 31, 2006, we had $1.0 million credit exposure on futures and $5.1 million credit exposure on interest rate agreements.

Note 8. Reserves for Credit Losses

We establish reserves for credit losses on our real estate loans based on our estimate of losses inherent in our loan portfolio.

Delinquencies in our consolidated residential real estate loan portfolio were $56 million and $65 million as of September 30, 2007 and December 31, 2006, respectively. Delinquencies include loans delinquent more than 90 days, in bankruptcy, and in foreclosure. As a percentage of our current residential real estate loan balances, delinquencies stood at 0.74% and 0.71% at September 30, 2007 and December 31, 2006, respectively. As a percentage of the original balances, delinquencies stood at 0.20% and 0.21% at September 30, 2007 and December 31, 2006, respectively.

Our residential loan servicers advance payment on delinquent loans to the extent they deem them recoverable. We accrue interest on loans until they are more than 90 days past due at which point they are placed on nonaccrual status. When a loan becomes REO, we estimate the specific loss, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest), and charge this specific estimated loss against the reserve for credit losses.

For the three months ended September 30, 2007, we had a total credit loss provision of $1.5 million. During the third quarter of 2007 we transferred $5.6 million (of principal value) of delinquent residential loans from held-for-investment to held-for-sale at the lower of cost or fair market value (LOCOM) with a corresponding reduction in the reserve for credit losses through charge-offs. The impact of these events was a $0.5 million net reduction of the balance sheet credit reserve.

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(Unaudited)

Note 8. Reserves for Credit Losses (continued)

The following table summarizes the activity in reserves for credit losses for our consolidated residential real estate loans for the three and nine months ended September 30, 2007 and 2006.

Residential Real Estate Loan Reserves for Credit Losses

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2007	2006	2007	2006
Balance at beginning of period	$ 16,416	$ 19,450	$ 20,119	$ 22,656
Provision for (reversal of) credit losses	1,507	465	5,488	(1,900)
Charge-offs	(2,728)	(589)	(10,412)	(1,430)
Balance at end of period	$ 15,195	$ 19,326	$ 15,195	$ 19,326

The following table summarizes the activity in reserves for credit losses for our commercial real estate loans for the three and nine months ended September 30, 2007 and 2006.

Commercial Real Estate Loan Reserves for Credit Losses

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2007	2006	2007	2006
Balance at beginning of period	$ 2,348	$	$	$
Provision for credit losses			2,348	35
Charge-offs				(35)
Balance at end of period	$ 2,348	$	$ 2,348	$

During the first quarter of 2007, we fully reserved for an anticipated loss on a junior mezzanine commercial loan financing a condominium-conversion project in the amount of $2.3 million. Principal and accrued interest on this loan was scheduled to be paid upon the completion of the project and sale of the units. Accordingly, the loan was not delinquent. However, due to cost overruns and changing market conditions, we believe it is unlikely we will collect any outstanding principal upon completion of the project. The provision for credit losses on commercial loans for the nine months ended September 30, 2007 relates to that loan.

Note 9. Other Assets

Other assets as of September 30, 2007 and December 31, 2006 are summarized in the following table.

Other Assets

(In Thousands)	September 30, 2007	December 31, 2006

Real estate owned (REO)	$ 14,345	$ 7,963
Fixed assets and leasehold improvements	7,129	4,439
Principal receivable	2,029	4,417
Purchased interest		1,045
Other	1,936	2,342
Total other assets	$ 25,439	$ 20,206

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NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 10. Redwood Debt

We enter into repurchase agreements, bank borrowings, and other forms of collateralized (and generally uncommitted) borrowings with several banks and major investment banking firms. We also issue commercial paper for financing residential and commercial real estate loans and securities. We refer to these borrowings as Redwood debt. We report Redwood debt at its unpaid principal balance. We also have other types of recourse debt such as subordinated notes (See *Note 12*).

The table below summarizes the outstanding balances of Redwood debt as of September 30, 2007 and December 31, 2006, by collateral type.

Redwood Debt

(In Thousands)	September 30, 2007 Number of Facilities	Outstanding	Limit	Maturity	
Facilities by collateral					
Real estate loans	4	$	$ 2,350,000	10/07	1/08
Real estate securities	11	39,378	4,287,000		
Unsecured line of credit	1		10,000	10/07	
Madrona commercial paper facility	1		490,000	7/09	
Total facilities	17	$ 39,378	$ 7,137,000		

(In Thousands)	December 31, 2006 Number of Facilities	Outstanding	Limit	Maturity

Facilities by collateral					
Real estate loans	5	$ 959,139	$ 2,700,000	1/07	10/07
Real estate securities	14	597,069	5,787,000		
Unsecured line of credit	1		10,000	10/07	
Madrona commercial paper facility	1	300,000	490,000	7/09	
Total facilities	21	$ 1,856,208	$ 8,987,000		

At September 30, 2007, we had $4.3 billion of uncommitted real estate securities facilities and $2.4 billion of uncommitted real estate loan facilities included within the limits above.

At September 30, 2007, Redwood debt was all short-term debt. Borrowings under these facilities generally bear interest based on a specified margin over the one-month LIBOR interest rate. For the three and nine months ended September 30, 2007, the average balance of Redwood debt was $0.4 billion and $1.4 billion, respectively, with a weighted-average interest cost of 5.87% and 5.84%, respectively. For the three and nine months ended September 30, 2006, the average balance of Redwood debt was $0.6 billion and $0.3 billion, with a weighted-average interest cost of 5.82% and 6.08%, respectively. At September 30, 2007 and December 31, 2006, accrued interest payable on Redwood debt was $30,000 and $7.0 million, respectively.

At September 30, 2007 we had no commercial paper outstanding. At December 31, 2006, we had $300 million of commercial paper outstanding through our Madrona special purpose entity.

The table below summarizes Redwood debt by weighted average interest rates and by collateral type in Redwood debt at September 30, 2007 and December 31, 2006.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 10. Redwood Debt (continued)

Redwood Debt

(In Thousands)	September 30, 2007 Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	December 31, 2006 Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
Real estate loan collateral	$			$ 1,259,139	5.54 %	21
Securities collateral	39,378	5.25 %	26	597,069	6.06 %	110
Total Redwood debt	$ 39,378	5.25 %	26	$ 1,856,208	5.71 %	49

The following table presents the remaining maturities of Redwood debt as of September 30, 2007 and December 31, 2006.

Redwood Debt

(In Thousands)	September 30, 2007	December 31, 2006
Within 30 days	$ 39,378	$ 1,259,138
31 to 90 days		392,566
Over 90 days		204,504
Total Redwood debt	$ 39,378	$ 1,856,208

As of September 30, 2007 we were in breach on four of our International Swaps and Derivatives Association agreement covenants with derivative counterparties due to a decline in total reported net worth. We have subsequently transferred these agreements to new counterparties whose covenants we are in compliance with. In addition, for the same total reported net worth reasons, we were in breach on three debt covenants. However, these facilities had zero balances at September 30, 2007. We continue to be in compliance with all other debt covenants for all of our borrowing arrangements and credit facilities. Covenants associated with our debt generally relate to our tangible net worth, liquidity reserves, and leverage requirements. While we generally do not anticipate having any problems in meeting most of our covenants on these arrangements, the possible future decline and volatility in our reported net worth may require us to renegotiate some covenants or reduce the number of counterparties with whom we transact business. It is our intention to renew committed and uncommitted facilities as needed, as well as pursue additional facilities and other types of financing.

Note 11. Asset-Backed Securities Issued

The Sequoia and Acacia securitization entities sponsored by us issue ABS to raise the funds to acquire assets from us and others. Each series of ABS consists of various classes that pay interest at variable and fixed rates. Substantially all of the variable-rate ABS are indexed to one-, three- or six-month LIBOR, with interest paid monthly or quarterly. A lesser amount of the ABS is fixed for a term and then will adjust to a LIBOR rate (hybrid ABS) or is fixed for its entire term. Some of the ABS securities issued are IOs and have coupons set at a fixed rate or a fixed spread, while others earn a coupon based on the spread between collateral owned by and the ABS issued by a securitized entity.

The maturity of each class of ABS is directly affected by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of an ABS is likely to occur earlier than its stated maturity.

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Note 11. Asset-Backed Securities Issued (continued)

The carrying value components of the collateral for ABS issued and outstanding as of September 30, 2007 and December 31, 2006 are summarized in the table below.

Collateral for Asset-Backed Securities Issued

(In Thousands)	September 30, 2007	December 31, 2006
Real estate loans	$7,649,695	$7,955,632
Real estate securities	2,520,899	2,175,806
Other real estate investments	1,200	
Real estate owned (REO)	12,286	7,963
Restricted cash owned by consolidated securitization entities	137,057	111,124
Accrued interest receivable	52,463	61,617
Total collateral for ABS issued	$10,373,600	$10,312,142

The components of ABS issued by consolidated securitization entities as of September 30, 2007 and December 31, 2006, along with other selected information, are summarized in the table below.

Asset-Backed Securities Issued

(In Thousands)	September 30, 2007	December 31, 2006
Sequoia ABS issued certificates with principal value	$7,325,264	$7,575,062
Sequoia ABS issued interest-only certificates	42,688	74,548
Acacia ABS issued	3,441,750	2,327,504
Madrona ABS issued	5,400	5,400
Unamortized discount on ABS	(12,574)	(3,290)
Total consolidated ABS issued	$10,802,528	$9,979,224
Sequoia ABS:		
Range of weighted average interest rates, by series	4.61% to 6.69 %	4.64% to 6.37 %
Stated maturities	2010 2047	2007 2046
Number of series	40	40
Acacia ABS:		
Range of weighted average interest rates, by series	5.73% to 6.29 %	5.84% to 6.03 %
Stated maturities	2039 2052	2038 2046
Number of series	10	8

Amortization of deferred asset-backed securities issuance costs were $17.4 million and $17.8 million for the nine months ended September 30, 2007 and 2006, respectively.

The following table summarizes the accrued interest payable on ABS issued as of September 30, 2007 and December 31, 2006. Interest due on Sequoia ABS is settled monthly and on Acacia ABS is settled quarterly.

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	September	December

	30, 2007	31, 2006
Sequoia	$ 21,520	$ 20,060
Acacia	39,629	23,137
Total accrued interest payable on ABS issued	$ 61,149	$ 43,197

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Note 12. Subordinated Notes

In December 2006, we issued $100 million of subordinated notes (trust preferred securities) through Redwood Capital Trust I, a wholly-owned Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than January 30, 2037. The earliest optional redemption date without a penalty is January 30, 2012.

In May 2007, we issued $50 million of subordinated notes which require quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than July 30, 2037. The earliest optional redemption date without a penalty is July 30, 2012.

At September 30, 2007 and December 31, 2006, the accrued interest payable balance on subordinated notes was $2.0 million and $0.4 million, respectively.

Note 13. Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. In order to qualify as a REIT, we must distribute at least 90% of our annual REIT taxable income (this does not include taxable income retained in our taxable subsidiaries) to stockholders within the time frame set forth in the tax rules and we must meet certain other requirements. We may retain up to 10% of our REIT ordinary taxable income (and currently intend to do so in 2007 as we did in 2006) and pay corporate income taxes on this retained income while continuing to maintain our REIT status. We distribute all net capital gains. We are also subject to income taxes on taxable income earned at our taxable subsidiaries.

We recognized a total tax provision of $1.8 million and $3.5 million for the three months ended September 30, 2007 and 2006, respectively. We recognized a total tax provision of $6.7 million and $9.6 million for the nine months ended September 30, 2007 and 2006, respectively.

Our tax provision is determined by applying our expected annual effective tax rate to our GAAP pre-tax income (loss). The effective tax rate is determined as the ratio of tax liability to annual GAAP pre-tax income (loss), based on estimates of taxable and GAAP annual income (loss) for the remainder of the year. Differences in taxable income from GAAP income (loss) reflect various accounting treatments for tax and GAAP, such as the accounting for discount and premium amortization, credit losses, stock options, compensation, asset impairments, changes in market valuations on certain assets, and hedges. Some of these differences create timing differences as to when the taxable income is earned, and the tax is paid, and when the GAAP income (loss) is recognized and the GAAP tax provision is recorded. Some of the differences are permanent as the income (or expense) may be recorded for tax and not for GAAP (or vice-versa). One such significant permanent difference is that, as a REIT, we are able to deduct for tax purposes the dividends paid to shareholders.

Our GAAP income (loss) and taxable income projections are adjusted to reflect actual results and may be revised based on updated information and these changes may lead to changes in our effective tax rate calculations over the course of the year. In the third quarter, our projections of GAAP income (loss) were adjusted as the result of the volatility in the pricing of assets and the subsequent negative market valuation adjustment recorded in the third quarter of 2007. As these negative market valuation adjustments generally do not have a tax effect until realized by sale of the asset, the projected tax liability was not generally affected but projected GAAP pre-tax income was significantly lowered. As a result of these revisions, our effective tax rate changed from our prior estimates.

We currently expect our 2007 taxable income before dividend distributions to be higher than our GAAP income (loss) primarily due to the accounting of discounts on CES and the market valuations taken on our assets for GAAP but not for tax. However, the dividend distribution of at least 90% of our REIT taxable

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Note 13. Taxes (continued)

income reduces our effective tax rate from the statutory levels. The following is a reconciliation of the statutory federal and state rates to the effective rates, as estimated for 2007 as of September 30, 2007 and for the full year of 2006.

Reconciliation of Statutory Tax Rate to Effective Tax Rate

	2007	2006
Federal statutory rate	35.0 %	35.0 %
State statutory rate, net of Federal tax effect	7.0 %	7.0 %
Differences in taxable income from GAAP income	206.6 %	11.6 %
Dividend paid deduction	(274.9)%	(46.3)%
Effective tax rate	(26.3)%	7.3 %

Our policy for interest and penalties on material uncertain tax positions recognized in the consolidated financial statements is to classify these as interest expense and operating expense, respectively. However, in accordance with Financial Accounting Standard Board Interpretation Number 48, *Accounting for Uncertainty in Income Taxes,* (FIN 48) we assessed our tax positions for all open tax years (Federal, years 2003 to 2006 and State, years 2002 to 2006) as of September 30, 2007 and concluded that we have no material FIN 48 liabilities to be recognized at this time.

Note 14. Fair Market Value of Financial Instruments

We estimate the fair market value of our financial instruments using available market information and other appropriate valuation methodologies. These fair market value estimates generally incorporate discounted future cash flows at current market discount rates for comparable investments. We validate our fair market value estimates on a quarterly basis by obtaining fair market value estimates from dealers for securities who make a market in these financial instruments and look at recent post period end acquisitions and sales. We believe the estimates we use reasonably reflect the values we may be able to receive should we choose to sell them. Many factors must be considered in order to estimate fair market values, including, but not limited to interest rates, prepayment rates, amount and timing of credit losses, supply and demand, liquidity, and other market factors. Accordingly, our estimates are inherently subjective in nature and involve uncertainty and judgment to interpret relevant market and other data. Amounts realized in actual sales may differ from the fair market values presented.

The following table presents the carrying values and estimated fair market values of our financial instruments as of September 30, 2007 and December 31, 2006.

Fair Market Value of Financial Instruments

	September 30, 2007		December 31, 2006	
(In Thousands)	Carrying Value	Fair Market Value	Carrying Value	Fair Market Value
Assets				
Real estate loans (held-for-investment)	$ 7,649,987	$ 7,527,701	$ 9,352,107	$ 9,268,914
Real estate loans (held-for-sale)	6,048	6,048		
Real estate securities (available-for-sale)	2,926,388	2,926,388	3,232,767	3,232,767
Other real estate investments (trading)	25,300	25,300		
Non-real estate investments	80,000	80,000		
Cash and cash equivalents	309,544	309,544	168,016	168,016

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
September 30, 2007
(Unaudited)

Note 14. Fair Market Value of Financial Instruments (continued)

(In Thousands)	September 30, 2007 Carrying Value	September 30, 2007 Fair Market Value	December 31, 2006 Carrying Value	December 31, 2006 Fair Market Value
Derivative assets	19,749	19,749	26,827	26,827
Restricted cash	137,062	137,062	112,167	112,167
Accrued interest receivable	50,473	50,473	70,769	70,769
Liabilities				
Redwood debt	39,378	39,378	1,856,208	1,856,208
ABS issued				
Sequoia	7,376,427	7,252,721	7,664,066	7,627,644
Acacia	3,420,654	2,837,101	2,309,673	2,302,427
Madrona	5,447	5,447	5,485	5,510
Total ABS issued	10,802,528	10,095,269	9,979,224	9,935,581
Derivative liabilities	28,477	28,477	6,214	6,214
Accrued interest payable	63,177	63,177	50,590	50,590
Subordinated notes	150,000	108,750	100,000	100,000

Methodologies we use to estimate fair market values for various asset types are described below.

Real estate loans

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

Commercial real estate loan fair market values are determined by appraisals on underlying collateral and discounted cash flow analyses.

Real estate securities

Real estate securities fair market values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions confirmed by third party dealer/pricing indications.

Other real estate investments

Other real estate investments fair market values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions confirmed by third party dealer/pricing indications.

Non-real estate investments

Non-real estate investments fair market value approximates carrying value as the coupon rate is at LIBOR resetting monthly.

Derivative assets and liabilities

Fair market values on interest rate agreements are determined by third party vendor modeling software and from valuations provided by dealers active in derivative markets.

Cash and cash equivalents

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

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Note 14. Fair Market Value of Financial Instruments (continued)

Restricted cash

Includes interest-earning cash balances in ABS entities for the purpose of distribution to bondholders and reinvestment. Due to the short-term nature of the restrictions, fair market values approximate carrying values.

Accrued interest receivable and payable

Includes interest due and receivable on assets and due and payable on our liabilities. Due to the short- term nature of when these interest payments will be received or paid, fair market values approximate carrying values.

Redwood debt

All Redwood debt is adjustable and matures within one year; fair market values approximate carrying values.

ABS issued

Fair market values are determined by discounted cash flow analyses and other valuation techniques confirmed by third party/dealer pricing indications

Commitments to purchase

Fair market values are determined by discounted cash flow analyses and other valuation techniques confirmed by third party/dealer pricing indications.

Subordinated notes

Fair market values are determined using comparable market indicators of current pricing.

Note 15. Stockholders Equity

Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) includes the difference between fair market value and amortized cost for both our real estate securities accounted for as AFS and our interest rate agreements accounted for as cash flow hedges. At September 30, 2007 the unrealized loss on AFS was $727 million, a decline of $813 million from the unrealized gain of $86 million at December 31, 2006.

Also included in accumulated other comprehensive income (loss) are any net gains or losses from interest rate agreements accounted for as cash flow hedges that have been terminated and where the hedge transactions are still likely to occur. At September 30, 2007, included in the $8.0 million of net unrealized losses on interest rate agreements were $3.3 million of net unrealized gains from terminated hedges, of which a minimal amount will be amortized into income over the next twelve months. At December 31, 2006, included in the $6.7 million of net unrealized gains on interest rate agreements were $0.6 million of net unrealized losses from terminated hedges.

The following table provides a summary of the components of accumulated other comprehensive income (loss) as of September 30, 2007 and December 31, 2006.

(In Thousands)	September 30, 2007	December 31, 2006
Net unrealized gains (losses) on real estate securities	$(727,115)	$ 86,434
Net unrealized gains (losses) on interest rate agreements accounted for as cash flow hedges	(7,967)	6,724
Total accumulated other comprehensive (loss) income	$(735,082)	$ 93,158

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 16. Equity Compensation Plans

Stock-Based Compensation

At January 1, 2006, upon adoption of FAS 123R, we had $19.3 million of unamortized costs related to unvested equity awards (stock options, restricted stock, and deferred stock units). At September 30, 2007, the unamortized costs totaled $12.1 million and will be expensed over the next six years, over half of which will be recognized over the next twelve months.

Incentive Plan

In March 2006, we amended the previously amended 2002 Redwood Trust, Inc. Incentive Stock Plan (Incentive Plan) for executive officers, employees, and non-employee directors. This amendment was approved by our stockholders in May 2006. The Incentive Plan authorizes our board of directors (or a committee appointed by our board of directors) to grant incentive stock options as defined under Section 422 of the Code (ISOs), options not so qualified (NQSOs), deferred stock units, restricted stock, performance shares, stock appreciation rights, limited stock appreciation rights (awards), and DERs to eligible recipients other than non-employee directors. ISOs and NQSOs awarded to employees and directors have a maximum term of ten years. Stock options, deferred stock units, and restricted stock granted to employees generally vest over a four-year period. Non-employee directors are automatically provided annual awards under the Incentive Plan that generally vest immediately. The Incentive Plan has been designed to permit the compensation committee of our board of directors to grant and certify awards that qualify as performance-based and otherwise satisfy the requirements of Section 162(m) of the Code. As of September 30, 2007 and December 31, 2006, 498,075 and 514,217 shares of common stock, respectively, were available for grant.

A summary of stock option activity during the three and nine months ended September 30, 2007 and 2006 is presented in the table below. See *Note 2* for a discussion on the assumptions used to value stock options at grant date.

Stock Options Activity

	Three Months Ended September 30,			
	2007		2006	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price

Stock Options Outstanding				
Outstanding options at beginning of period	1,007,849	$ 34.81	1,507,226	$ 33.19
Options granted				
Options exercised	(400)	32.99	(5,375)	32.25
Options forfeited	(1,886)	57.93	(101)	33.13
Outstanding options at period-end	1,005,563	$ 34.77	1,501,750	$ 33.20
Options exercisable at period-end	940,291	$ 33.30	1,317,160	$ 30.65
Weighted average fair market value of options granted during the period		$		$

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 16. Equity Compensation Plans (continued)

	Nine Months Ended September 30, 2007		2006	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Stock Options Outstanding				
Outstanding options at beginning of period	1,072,622	$ 34.70	1,548,412	$ 32.60
Options granted	15,934	55.73	33,871	41.09
Options exercised	(64,572)	32.49	(79,016)	24.68
Options forfeited	(18,421)	56.80	(1,517)	40.63
Outstanding options at period-end	1,005,563	$ 34.77	1,501,750	$ 33.20
Options exercisable at period-end	940,291	$ 33.30	1,317,160	$ 30.65
Weighted average fair market value of options granted during the period		$ 4.30		$ 3.41

With the adoption of FAS 123R on January 1, 2006, the grant date fair market value of all remaining unvested stock options (which includes the value of any future dividend equivalent rights) is expensed to the consolidated statements of income (loss) over the remaining vesting period of each option.

For the three and nine months ended September 30, 2007, expenses related to stock options were $0.1 million and $1.1 million, respectively. For the three and nine months ended September 30, 2006, expenses related to stock options were $0.5 million and $1.5 million, respectively. As of September 30, 2007, there was $0.8 million of unrecognized compensation cost related to unvested stock options. These costs will be expensed over a weighted-average period of one year.

The total intrinsic value or gain (fair market value less exercise price) for options exercised was $2,000 and $1.4 million for the three and nine months ended September 30, 2007, respectively. The net cash proceeds received from the exercise of stock options was $11,000 and $1.2 million for the three and nine months ended September 30, 2007, respectively.

The total gain for options exercised was $0.1 million and $1.4 million for the three and nine months ended September 30, 2006, respectively. The net cash proceeds received from the exercise of stock options was $0.2 million and $0.6 million for the three and nine months ended September 30, 2006, respectively.

The aggregate intrinsic value of the options outstanding and options currently exercisable was $8.7 million and $25 million at September 30, 2007 and December 31, 2006, respectively.

In the first nine months of 2007, officers exercised 23,487 options and surrendered 15,715 shares to pay exercise costs and taxes of $1 million on the gains on the options exercised.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 16. Equity Compensation Plans (continued)

The following table summarizes information about stock options outstanding at September 30, 2007.

Stock Options Exercise Prices as of September 30, 2007

	Options Outstanding			Options Exercisable	
Range of Excise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$10 to $20	314,783	1.90	$ 12.90	314,783	$ 12.90
$20 to $30	200,665	1.03	21.58	200,665	21.58
$30 to $40	2,500	5.61	36.19	2,500	36.19
$40 to $50	49,271	4.95	43.35	49,221	43.35
$50 to $60	438,344	6.10	55.54	373,122	55.46
$0 to $60	1,005,563	3.72		940,291	

Restricted Stock

As of September 30, 2007 and December 31, 2006, 21,296 and 27,524 shares, respectively, of restricted stock were outstanding. Restrictions on these shares lapse through January 2011.

Restricted stock activity for the three and nine months ended September 30, 2007 and 2006 is presented in the table below. There were no restricted stock awards granted during the first nine months of 2007.

Restricted Stock Outstanding

	Three Months Ended September 30, 2007		Three Months Ended September 30, 2006	
	Shares	Weighted Average Grant Date Fair Market Value	Shares	Weighted Average Grant Date Fair Market Value
Restricted stock outstanding at the beginning of period	22,252	$ 50.02	18,186	$ 45.57
Restricted stock granted				
Stock for which restrictions lapsed	(62)	40.49		
Restricted stock forfeited	(894)	51.75	(436)	46.13
Restricted stock outstanding at end of period	21,296	$ 49.97	17,750	$ 45.55

	Nine Months Ended September 30, 2007		Nine Months Ended September 30, 2006	
	Shares	Weighted Average Grant Date Fair Market Value	Shares	Weighted Average Grant Date Fair Market Value
Restricted stock outstanding at the beginning of period	27,524	$ 49.57	21,038	$ 45.96
Restricted stock granted			247	40.49
Stock for which restrictions lapsed	(4,370)	46.79	(972)	53.74
Restricted stock forfeited	(1,858)	51.51	(2,563)	45.32
Restricted stock outstanding at end of period	21,296	$ 49.97	17,750	$ 45.55

The cost of these grants is amortized over the vesting term using an accelerated method in accordance with FASB Interpretation No. 28 *Accounting for Stock Appreciation Rights and Other Variable Stock Options or Award Plans* (FIN 28), and FAS 123R. For both the three months ended September 30, 2007 and 2006, the

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 16. Equity Compensation Plans (continued)

expenses related to restricted stock were $0.1 million. For the nine months ended September 30, 2007 and 2006, the expenses related to restricted stock were $0.3 million and $0.2 million, respectively. As of September 30, 2007, there was $0.5 million of unrecognized compensation cost related to unvested restricted stock. This cost will be recognized over a weighted average period of one year.

Deferred Stock Units

Deferred stock units (DSUs) are granted or purchased by participants in the Executive Deferred Compensation Plan. Some of the DSUs awarded may have a vesting period associated with them. Restrictions on some of the outstanding DSUs lapse through 2013.

For the three and nine months ended September 30, 2007, expenses related to DSUs were $2.4 million and $9.4 million, respectively. For the three and nine months ended September 30, 2006, expenses related to DSUs were $2.0 million and $6.5 million, respectively. As of September 30, 2007, there was $10.8 million of unrecognized compensation cost related to nonvested DSUs. This cost will be recognized over a weighted-average period of one year. As of December 31, 2006, there was $19.4 million of unrecognized compensation cost related to nonvested DSUs. As of September 30, 2007 and December 31, 2006, the number of outstanding DSUs that had vested was 273,436 and 153,073, respectively.

The tables below provide summaries relating to the DSUs balances as of September 30, 2007 and December 31, 2006, and activity, including the three and nine months ended September 30, 2007.

Deferred Stock Units

(In Thousands)	September 30, 2007	December 31, 2006
Value of DSUs at grant	$ 38,225	$ 36,542
Participant forfeitures	(1,206)	(110)
Distribution of DSUs	(2,715)	(347)
Change in value at period end since grant	(11,032)	6,763
Value of DSUs at end of period	$ 23,272	$ 42,848

Deferred Stock Units Activity

(In Thousands, Except Unit Amounts)	Three Months Ended September 30, 2007			2006		
	Units	Fair Market Value	Weighted Average Grant Date Fair Market Value	Units	Fair Market Value	Weighted Average Grant Date Fair Market Value

Balance at beginning of period	710,941	$ 34,395	$ 49.24	492,371	$ 24,042	$ 45.31
Grants of DSUs	9,247	340	36.77	1,025	50	48.46
Distribution of DSUs	(3,216)	(161)	50.14			
Change in valuation during period		(10,418)			760	
Participant forfeitures	(16,385)	(884)	53.96			
Net change in number/value of DSUs	(10,354)	(11,123)		1,025	810	
Balance at end of period	700,587	$ 23,272	$ 48.96	493,396	$ 24,852	$ 45.32

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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Note 16. Equity Compensation Plans (continued)

	Nine Months Ended September 30,					
	2007			2006		
(In Thousands, Except Unit Amounts)	Units	Fair Market Value	Weighted Average Grant Date Fair Market Value	Units	Fair Market Value	Weighted Average Grant Date Fair Market Value
Balance at beginning of period	737,740	$ 42,848	$ 48.91	418,126	$ 17,252	$ 45.65
Grants of DSUs	33,880	1,683	49.68	86,741	3,617	41.70
Distribution of DSUs	(50,498)	(2,368)	46.90	(11,471)	(347)	30.27
Change in valuation during period		(17,795)			4,330	
Participant forfeitures	(20,535)	(1,096)	53.38			
Net change in number/value of DSUs	(37,153)	(19,576)		75,270	7,600	
Balance at end of period	700,587	$ 23,272	$ 48.96	493,396	$ 24,852	$ 45.32

Executive Deferred Compensation Plan

In May 2002, our board of directors approved the 2002 Executive Deferred Compensation Plan (EDCP). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. Redwood matches some deferrals. Compensation deferred under the EDCP are assets of Redwood and subject to the claims of the general creditors of Redwood. The EDCP allows for the investment of deferrals in either an interest crediting account or additional DSUs. The rate of accrual in the interest crediting account is set forth in the EDCP. For deferrals prior to July 1, 2004, the accrual rate is based on a calculation of the marginal rate of return on our portfolio of earning assets. For deferrals after July 1, 2004 and through December 31, 2006, the accrual rate is based on 120%

of the long-term applicable federal rate (AFR) or the equivalent rate of employee preselected publicly traded mutual funds. For deferrals subsequent to December 31, 2006 and beginning July 1, 2007, for all prior deferrals the accrual rate is based on 120% of AFR. Participants may also use their deferrals to acquire additional DSUs.

For the three and nine months ended September 30, 2007, deferrals of $0.1 million and $1.5 million, respectively, were made under the EDCP. For the three and nine months ended September 30, 2006, deferrals of $0.5 million and $2.4 million, respectively, were made under the EDCP.

The following table provides detail on changes in participants EDCP accounts for the three and nine months ended September 30, 2007 and 2006.

EDCP Activity

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2007	2006	2007	2006
Transfer into participants EDCP accounts	$ 136	$ 494	$ 1,484	$ 2,418
Accrued interest earned in EDCP	297	269	817	773
Participants withdrawals	(50)		(3,424)	(2,120)
Net change in participants EDCP accounts	$ 382	$ 763	$ (1,123)	$ 1,071
Balance at beginning of period	$ 8,187	$ 7,313	$ 9,693	$ 7,005
Balance at end of period	$ 8,570	$ 8,076	$ 8,570	$ 8,076

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NOTES TO FINANCIAL STATEMENTS September 30, 2007 (Unaudited)

Note 16. Equity Compensation Plans (continued)

The following table provides detail on the financial position of the EDCP at September 30, 2007 and December 31, 2006.

Balance of Participants EDCP Accounts

(In Thousands)	September 30, 2007	December 31, 2006
Participants deferrals	$ 5,807	$ 6,643
Accrued interest credited	2,763	3,050

Balance of participants EDCP accounts	$ 8,570	$ 9,693

Employee Stock Purchase Plan

In May 2002, our stockholders approved the 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP), effective July 1, 2002. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in Redwood through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair market value, subject to limits. Fair market value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter of that year.

The ESPP allows a maximum of 100,000 shares of common stock to be purchased in aggregate for all employees. As of September 30, 2007 and December 31, 2006, 44,729 and 35,570 shares have been purchased, respectively. As of September 30, 2007 and December 31, 2006, there remained a negligible amount of uninvested employee contributions in the ESPP.

The table below presents the activity in the ESPP for the three and nine months ended September 30, 2007 and 2006.

Employee Stock Purchase Plan

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2007	2006	2007	2006
Balance at beginning of period	$10	$ 5	$3	$ 13
Transfer in of participants payroll deductions from the ESPP	114	99	362	283
Cost of common stock issued to participants under the terms of the ESPP	(123)	(102)	(364)	(294)
Net change in participants equity	$(9)	$ (3)	$(2)	$ (11)
Balance at end of period	$1	$ 2	$1	$ 2

Note 17. Commitments and Contingencies

As of September 30, 2007, we were obligated under non-cancelable operating leases with expiration dates through 2018 for $15.8 million. The majority of the future lease payments relate to a ten-year operating lease for our executive offices, which expires in 2013, and a lease for additional office space at our executive offices beginning January 1, 2008 and expiring May 31, 2018. Prior to the beginning of the lease of the additional office space, we are subleasing this office space from another tenant through the end of 2007. The total lease payments to be made under the lease expiring in 2013 and the sublease, including certain free-rent periods, are being recognized as office rent expense on straight-line basis over the lease term. Operating lease expense was $0.3 million for both the three months ended September 30, 2007 and 2006. Operating lease expense was

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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Note 17. Commitments and Contingencies (continued)

$1.0 million and $0.6 million for the nine months ended September 30, 2007 and 2006, respectively. Leasehold improvements for our executive offices are amortized into expense over the ten-year lease term. The unamortized leasehold improvement balance at September 30, 2007 and December 31, 2006 was $3.3 million and $2.0 million, respectively.

Future Lease Commitments by Year

(In Thousands)	September 30, 2007
2007 (three months)	$ 339
2008	1,636
2009	1,680
2010	1,709
2011	1,831
2012 and thereafter	8,574
Total	$ 15,769

At September 30, 2007, to our knowledge there were no legal proceedings to which we were a party or to which any of our properties was subject.

At September 30, 2007 we had no loan purchase commitments to be recorded under FAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149). The change in value of commitments during the quarter is included in market valuation adjustments, net on our consolidated statements of income (loss).

Stock Repurchases

We announced stock repurchase plans on various dates from September 1997 through November 1999 for the total repurchase of a total of 7,455,000 shares. None of these plans have expiration dates. There were no repurchases during the third quarter of 2007 and 1,000,000 shares remained available for repurchase under those plans.

Note 18. Recent Developments

On November 5, 2007, our Board of Directors authorized Redwood to purchase of up to 5,000,000 shares of Redwood common stock. The Board authorization replaces a previously Board-authorized stock purchase program under which Redwood had remaining authority to purchase up to 1,000,000.

On November 5, 2007 our Board of Directors declared a $0.75 per share dividend for the fourth quarter payable on January 22, 2008 to stockholders of record as of December 31, 2007 and a special dividend of $2.00 per share for 2007 payable on December 7, 2007 to stockholders of record as of November 26, 2007.

On October 11, 2007, Moody's Investors Service downgraded a number of securities issued in 2006 backed by sub prime first lien mortgages. We incorporated this downgrade information as it applies to securities we owned as of September 30, 2007 into our third quarter mark-to-market process and assessment of EITF 99-20 impairments.

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

Cautionary Statement

This Form 10-Q contains forward-looking statements within 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 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, p expressions or their negative forms, 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 year ended December 31, 2006 under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are described below and may be described from time to time in reports we file with the Securities and Exchange Commission (SEC), including reports on Forms 10-K, 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.

Important factors, among others, that may affect our actual results include: changes in interest rates; changes in prepayment rates; general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the availability of high quality assets for purchase at attractive prices; declines in home prices; increases in mortgage payment delinquencies; changes in the level of liquidity in the capital markets which may adversely affect our ability to finance our real estate asset portfolio; changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets, rating agency downgrades of securities and increases in the supply of real estate securities available for sale, each of which may adversely affect the values of securities we own; the extent of changes in the values of securities we own and the impact of adjustments reflecting those changes on our income statement and balance sheet, including our stockholders equity; our ability to maintain the positive stockholders equity necessary to enable us to pay the dividends required to maintain our status as a real estate investment trust for tax purposes; and other factors not presently identified. This Form 10-Q contains 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.

Summary

Our Business

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), is a financial institution focused on investing in, financing, and managing residential and commercial real estate loans and securities. We seek to invest in assets that have the potential to provide high cash flow returns over a long period of time to help support our goal of distributing attractive levels of dividends per share. For tax purposes, we are structured as a real estate investment trust (REIT).

Our primary source of income is net interest income, which equals the interest income we earn from our investments in loans and securities less the interest expenses we incur from our borrowed funds and other liabilities. We assume a range of risks in our investments and the level of assumed risk dictates the manner in which we finance our purchase of and derive income from these investments.

Our investments in residential, commercial, and collateralized debt obligation (CDO) credit enhancement securities (CES, or below investment-grade securities) have concentrated credit risk. We finance the acquisition of most of our first-loss and equivalent CES that are directly exposed to credit losses with capital. We generally finance the acquisition of our second-loss, third-loss, and equivalent securities through our Acacia securitization program. To date, our primary credit enhancement investment focus has been in securities backed by high-quality residential and commercial real estate loans. High-quality real estate loans are loans that typically have low loan-to-value ratios, borrowers with strong credit histories, and other indications of quality relative to the range of loans within U.S. real estate markets as a whole. Our CES investment returns depend on the amount and timing of most of the interest and principal collected on the loans in the pools supporting the securities. In an ideal environment for most of our residential CES, we

would experience fast loan prepayments and low credit losses which would, in turn, lead to attractive CES returns. Conversely, the return on most of our residential CES investments would be adversely affected by slow loan prepayments and high credit losses.

Our investments in real estate loans and investment-grade securities (IGS) have less concentrated credit risk. To produce an attractive investment return on these lower credit risk assets, we use leverage (primarily structural leverage through securitization rather than financial leverage through the use of Redwood debt). We earn income based upon the spread between the yield on the acquired asset and the cost of funds we borrowed to acquire the asset. We have obtained most of the financing used to acquire these assets through the issuance of asset-backed securities (ABS) under our Sequoia and Acacia securitization programs. These financings are not obligations of Redwood.

Results

The extensive price decline in real-estate securities that began earlier in the year accelerated during the third quarter and had a significant negative financial reporting impact on Redwood, as mark-to-market (MTM) adjustments to our real estate securities portfolio caused our GAAP book value and our GAAP earnings to decline significantly. We strongly believe the real economic impact on Redwood of diminished market values is significantly less severe than the financial reporting impact reflected in our GAAP financial statements. The primary reason for the divergence between economics and GAAP is the accounting treatment required for our investments in our Acacia CDO entities, which requires us to mark-to-market the assets owned by Acacia entities, but does not permit us to mark-to-market paired Acacia CDO issued liabilities. As a result of the GAAP accounting treatment, our investment in Acacia entities at the end of the third quarter was carried on our consolidated GAAP balance sheet with a negative stockholders equity balance of $580 million. From an economic perspective, the lowest possible economic value of our investments in the Acacia entities is zero. We believe our Acacia investments have positive value. We believe our September 30, 2007 consolidated stockholders equity of $149 million understates the value of our investment in Acacia entities by at least $580 million. See detailed Mark-to-Market Valuation Adjustments discussion below.

Our reported GAAP net loss was $61 million ($2.18 per share) in the third quarter of 2007, a decrease from net income of $32 million ($1.22 per share) for the third quarter of 2006. For the nine months ended September 30, 2007, our GAAP net loss was $31 million ($1.14 per share) a decrease from net income of $92 million ($3.51 per share) for the same period last year. Our GAAP return on equity was negative 29% for the three months ended September 30, 2007 compared to 13% for the three months ended September 30, 2006. GAAP return on equity was negative 4% for the nine months ended September 30, 2007 compared to 12% for the nine months ended September 30, 2006. In the third quarter of 2007, we declared a regular quarterly dividend of $0.75 per share. On November 5, 2007, our Board of Directors declared a $0.75 per share dividend for the fourth quarter payable on January 22, 2008 to stockholders of record as of December 31, 2007 and a special dividend of $2.00 per share for 2007 payable on December 7, 2007 to stockholders of record as of November 26, 2007.

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Table 1 Net Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands, Except Share Data)	2007	2006	2007	2006
Total interest income	$ 218,824	$ 223,649	$ 653,588	$ 667,769
Total interest expense	(165,230)	(174,673)	(499,083)	(528,847)
Net interest income	53,594	48,976	154,505	138,922
Operating expenses	(11,732)	(13,455)	(42,286)	(42,074)
Realized gains on sales and calls, net	1,824	5,690	5,708	15,740
Market valuation adjustments, net	(102,766)	(5,257)	(142,460)	(11,184)
Provision for income taxes	(1,837)	(3,538)	(6,659)	(9,563)
Net (loss) income	$ (60,917)	$ 32,416	$ (31,192)	$ 91,841
Diluted common shares	27,892,199	26,624,532	27,388,185	26,132,000
Net (loss) income per share	$ (2.18)	$ 1.22	$ (1.14)	$ 3.51

By far the largest factor in the decline of net income for the third quarter was a $98 million increase in negative mark-to-market valuation adjustments. Another factor negatively affecting our net income relative to the prior year third quarter was a $4 million decline from gains generated from sales and calls of assets.

On the positive side, our operating results for the third quarter of 2007 were strong. Net interest income increased to $54 million during the quarter, up from $49 million in the same period last year. Higher net interest income from our CES and IGS portfolios more than offset the decline from a reduced balance of adjustable-rate residential loans under our Sequoia program. Operating expenses were $12 million as compared to $13 million in the third quarter in 2006 primarily due to a reduction in compensation expense due to lower bonus accruals.

Our estimated taxable income was $1.74 per share and $4.88 per share for the three and nine months ended September 30, 2007, respectively. Our estimated REIT taxable income was $1.74 per share and $4.66 per share for the three and nine months ended September 30, 2007, respectively. Our REIT taxable income is the primary determinant of the minimum amount of dividends we must distribute in order to maintain our tax status as a real estate investment trust. Taxable income continues to run higher than GAAP income as we are not permitted to establish MTM valuation allowances or credit reserves for tax. We amortize more of our CES discount into income for tax and have a higher tax basis in these securities. Consequently, any future credit losses on our CES will have a more significant impact on tax earnings compared to GAAP earnings. See Potential Income Tax Volatility later in this document.

Quarterly Activity

Given the turmoil in the capital markets during the quarter, we limited our acquisition activity and focused our efforts on further strengthening our liquidity position and freeing up capital for deployment into higher yielding assets. We also focused our efforts on fostering and reinforcing business relationships to assure our business partners of our long-term positive market outlook.

During the third quarter, in order to free up capital, we securitized our whole loan inventory and sold AAA-rated securities. We realized some small losses on our asset sales, and the securitizations we completed during the quarter will likely generate a small negative yield for us in future quarters since the securities were sold at relatively high yields. Under the circumstances, we considered these outcomes to be an acceptable price to pay to free up capital for new asset acquisitions.

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Capital and Liquidity

During the quarter, we took several actions to improve our overall liquidity position by increasing cash levels and decreasing our reliance on short-term borrowing which have become unstable. Our net liquidity position was strong at the beginning of the quarter and even stronger at the end of the quarter.

Table 2 Liquidity Position

(In Millions) (Unaudited)	September 30, 2007	June 30, 2007
Unrestricted cash	$ 310	$ 83
Unsecuritized residential loans	6	888
AAA-rated residential securities	45	168
Liquid assets	361	1,139
Repo and CP borrowings	(39)	(849)
Net liquidity position	$ 322	$ 290

At September 30, 2007, we had $298 million of excess capital, an increase from the $158 million excess capital we had at June 30, 2007 and the $183 million with which we began the year. We derive our excess capital figures by calculating the amount of cash we have available for investment if we fully leveraged our loans and securities in accordance with our internal risk-adjusted capital policies and deducted from the resulting cash balances an amount we believe is sufficient to fund operations and working capital, and provide for any liquidity risks. We include long-term subordinated notes as part of our capital base calculations.

Uses of capital during the nine month period ended September 30, 2007 included acquisitions ($365 million) and dividends ($63 million). Sources of capital included sales ($85 million), net recycling of capital through securitization ($184 million), equity issuance ($60 million), issuance of subordinated notes ($50 million), and net cash flows received from our portfolio after operating costs ($164 million).

We believe our strengthened liquidity and capital positions provide us with options and flexibility. We are well positioned to build our franchise and make good long-term investments in our core residential and commercial credit-enhancement business. In addition, if we believe Redwood shares are trading at attractive levels relative to other uses of cash, we have the liquidity and capital resources to repurchase Redwood shares. In that regard, on November 5, 2007, Redwood s Board of Directors authorized Redwood to purchase up to 5,000,000 shares of Redwood common stock. The Board authorization replaces a previously Board-authorized stock purchase program under which Redwood had remaining authority to purchase up to 1,000,000 shares.

In the near term, we expect to finance most of our new investments with capital. In today s turbulent market, CDO financing is unavailable and short-term borrowing facilities remain unstable. This condition will temporarily slow our acquisitions of loans and investment-grade securities, but it will not impact the acquisition of core residential and commercial credit-enhancement securities as we fund these assets with capital. We are beginning to see some attractive core business opportunities, in particular, for new and seasoned prime residential credit-enhancement securities.

Our rate of excess capital utilization will depend on future market conditions. In this market, large and attractive investment opportunities may arise suddenly. We expect that our current excess capital will be absorbed during the next one to three quarters.

Outlook

We believe the well publicized liquidity crisis has brought some long overdue changes to the residential and commercial mortgage markets. A renewed appreciation for credit risk has new asset spreads at the widest levels we have seen in years. More stringent underwriting is leading to improvements in loan quality, and the overall level of exuberance has greatly subsided. We have started to make attractive investments in new residential transactions and in seasoned assets sold at a discount by forced sellers. We expect to have excellent residential and commercial investment opportunities going forward, both for our balance sheet and for one or more third-party asset management accounts we intend to generate and market to generate fee income for Redwood.

We are also pursuing attractive investment opportunities to acquire CDO and subprime securities that are trading at high risk-adjusted returns. This represents a growing market opportunity that we believe could offer exceptional upside potential. Our subprime and CDO structuring and investment expertise gives us a competitive advantage in evaluating these investments. As we continue to allocate capital to our core residential and commercial credit-enhancement businesses, we expect that our capital available for investments in CDO and subprime securities will be limited. For that reason, we are considering raising third-party capital through a new fund to invest in these securities. Redwood will be an investor in and the asset manager of the fund. This structure will allow us to take advantage of market opportunities, expand our asset management business, and benefit from some of the potential investment upside.

Overall, credit preformance for our residential credit-enhancement securities (CES) remains favorable relative to our modeling expectations and reserve levels. Realized credit losses for tax remain low at $2 million for the quarter. Credit performance trends vary by the underlying collateral type and loan vintage. Our CES portfolio (by unpaid principal balance) is backed 77% by prime loans, 20% by alt-a option ARMs, and 3% by other alt-a loans and subprime. By vintage, 73% of our CES portfolio was originated in 2005 and prior and 27% was originated in 2006 and 2007. Credit performance for CES backed by 2005 and prior prime and alt-a option ARM loan vintages continues to exceed our initial modeling expectations. The credit performance for 2006 and 2007 for these same loan types is in line with our initial expectations, but is beginning to trend worse. While these loans were made to strong borrowers, we believe that ultimate credit performance will be closely tied to the economy, home prices, and interest rates. A slowing economy, higher unemployment, or further declines in home prices would have a negative impact, while further decreases in mortgage rates would offer an opportunity for some of these borrowers to refinance and would have a favorable impact. The credit performance for CES backed by other alt-a and subprime loans, which is a relatively small investment for us, is performing worse than our expectations.

We are also closely watching the credit performance of residential and CDO investment grade securities backed by 2006 and 2007 subprime and weak alt-a borrowers. These securities have incurred numerous downgrades from the rating agencies. Over 98% of these securities were financed through Acacia and our capital exposure is limited. These securities are preforming significantly worse than our initial credit expectations. Declining home prices, tightening credit standards, and little or no equity in their homes have left many of these borrowers with no option to refinance or modify their loans. Given the early results and the unfavorable outlook, we have reassessed and significantly increased our loss expectations on these securities.

The credit performance for our commerical CES remains strong. Credit losses on this portfolio to date total less than one basis point (.01%) of the underlying loans.

We expect that over the next two to three years, we will likely experience delinquencies and credit losses that will increase materially on a percentage basis in comparison to the low levels we experienced over the last few years. However, we believe we have established appropriate reserves for these increased losses and we expect most of our assets to produce healthy economic returns even with the increased losses that we currently anticipate. That being said, we do not know how long or how severe this credit cycle will be, and our current expectations about the level of future losses could be overly optimistic.

Overall, we believe the most appropriate expectation over the next few years is that credit losses will escalate and likely reduce the amount of our special dividends in the next several years. In a severe case a case that we are not expecting despite current market turmoil taxable income alone may be less than our regular dividend for some period of time.

Nevertheless, we believe we are in a great position, with a rare opportunity to invest and strengthen our business, given that many of our competitors have suffered from the impact of this market turmoil, most of our assets will continue to generate healthy cash flows, and we have a strong liquidity position with a lack of short-term debt and a large balance of cash to invest.

We have been through several liquidity and credit cycles in the past. Each time we have emerged as a stronger company, and we believe we are well positioned to do so again this time around. Our current liquidity position and our balance sheet are strong, and we believe we are in a good position to continue to develop our businesses and our competitive advantages over time.

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Mark-to-Market Adjustment Discussion

Market Conditions

The mortgage market faced adversity in the third quarter of 2007 as the continued broad re-pricing of mortgage credit risk led to a severe contraction in market liquidity. The most dramatic price adjustments involved residential mortgage-backed securities (RMBS) and CDO securities backed by subprime and alt-a mortgages originated in 2006 and 2007.

We believe several converging factors led to the broad re-pricing, including general concerns over the decline in home prices, the rapid increase in the number of delinquent subprime and alt-a loans, the reduced willingness of investors to acquire commercial paper backed by mortgage collateral and the resulting contraction in market liquidity and availability of financing lines, the numerous rating agency downgrades of securities, and the increase in supply of securities potentially available for sale.

The downward spiraling of negative pricing adjustments on assets had a snowball effect as lower prices led to increased lender margin calls for some market participants, which in turn, forced additional selling, causing yet further declines in prices. These events continued to feed off each other through much of the quarter.

Normal market trading activity during the quarter was unusually light as uncertainty related to future loss estimates made it difficult for willing buyers and sellers to agree on price. This condition was particularly acute with respect to RMBS and CDO securities backed by 2006 and 2007 subprime and alt-a loans where market participants are setting price levels based on widely varied opinions about future loan performance and loan loss severity. While the early credit performance for these securities has been clearly far worse than initial expectations, the ultimate level of realized losses will largely be influenced by events that will likely unfold over the next 12 to 36 months, including the severity of housing price declines and the overall strength of the economy.

The actions taken late in the quarter by the Federal Reserve to reduce the federal funds and discount rates provided some temporary market confidence. We caution that Federal Reserve actions alone are not likely to result in price stability as the aforementioned market concerns remain largely unresolved. From the end of the third quarter through the beginning of November, prices for RMBS and CDO securities continued to decline, in particular for those securities backed by 2006 and 2007 subprime loans.

Impact on Redwood

We believe that, in the long run, the widening spreads (reduction in asset prices) will be advantageous to us as we are buying and will continue to buy high quality assets at more attractive prices than we have seen in recent years.

During the quarter, we experienced no liquidity issues as all of our credit-sensitive investments were financed with capital or through our Acacia securitization entities. Additionally, we only had a small amount of less credit sensitive assets borrowed on repo facilities. Our cash balances exceed our short-term debt.

The continued extensive price decline in real estate securities in the third quarter had a significant negative GAAP financial reporting impact on Redwood, as mark-to-market (MTM) adjustments to our real estate securities portfolio caused our GAAP book value and our GAAP earnings to decline significantly. We strongly believe that the real economic effect of MTM is significantly less than the impact shown under GAAP. The primary reason for the divergence between economics and GAAP is the accounting treatment required for our investments in Acacia CDOs.

As a result of this accounting treatment, our investments in Acacia CDO entities, in which we have a net cash investment of $113 million, are carried in our reported GAAP consolidated statement of stockholders equity as having $580 million of negative book value at September 30, 2007. (See the non-GAAP pro forma consolidating balance sheet below). However, economically this investment cannot be worth less than zero, because even in the worst case, we cannot lose more than the amount we invested. Nonetheless, GAAP requires us to prepare our financials in a manner that could cause readers to conclude that we did lose more than we invested. The debt of Acacia is not an obligation of Redwood and we have not provided Acacia with any guarantees. Therefore, even if you assume that our investment in Acacia is worthless, our reported GAAP book value is understated by $580 million. Furthermore, we believe that our investments in Acacia have positive value and will continue to generate cash flow. Our calculation of the present value of the future cash flows (adjusted for projected credit losses) from Acacia entities discounted at 45% and 14% range from $55 million to $145 million. Due to the current market illiquidity for CDO equity, we would expect that the fair value of our Acacia investments to be on the lower end of the range rather than the higher end.

Unless the decline in prices that occurred early in the fourth quarter of 2007 recover by year end, we would be required to record additional mark-to-market valuation adjustments in the fourth quarter. These adjustments could result in our reporting negative stockholders equity at December 31, 2007.

Table 3 Non-GAAP Pro Forma Consolidating Balance Sheet

September 30, 2007 (In Millions) (Unaudited)	Redwood Excluding Acacia	Acacia	Intercompany Adjustments	Redwood Consolidated
Real estate loans	$ 7,630	$ 26	$	$ 7,656
Real estate & other securities	429	2,715	(113)	3,031
Cash and cash equivalents	310			310
Total earning assets	8,369	2,741	(113)	10,997
Restricted cash	14	123		137
Other assets	95	54		149
Total Assets	$ 8,478	$ 2,918	$ (113)	$ 11,283
Redwood debt	$ 39	$	$	$ 39
Asset-backed securities issued	7,500	3,416	(113)	10,803
Subordinated notes	150			150
Other liabilities	60	82		142
Total Liabilities	7,749	3,498	(113)	11,134
Total Stockholders Equity	729	(580)		149
Total Liabilities and Stockholders Equity	$ 8,478	$ 2,918	$ (113)	$ 11,283

The purpose of this pro forma presentation is to show the consolidating components to our balance sheet and to highlight the negative impact that Acacia has on our consolidated stockholders equity at quarter end. The Redwood excluding Acacia column reflects Redwood without any investment in Acacia entities. While the components reconcile to our consolidated GAAP balance sheet, this is a non-GAAP presentation. In a GAAP presentation, the Redwood excluding Acacia balance sheet shown above would have reflected an investment in Acacia and reflected the negative equity of Acacia.

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Table 4 Non-GAAP Pro Forma Consolidating Income Statements

September 30, 2007 (In Millions) (Unaudited)	Three Months Ended September 30, 2007		
	Redwood Excluding Acacia	Acacia	Redwood Consolidated

Net Interest Income	$ 42	$ 12	$ 54
Operating expenses	(12)		(12)
Realized gains on sales and calls, net	2		2
Market valuation adjustments, net	(18)	(85)	(103)
Net income (loss) before provision for income taxes	14	(73)	(59)
Provision for income taxes	(2)		(2)
Net Income (Loss)	$ 12	$ (73)	$ (61)

	Nine Months Ended September 30, 2007		
	Redwood Excluding Acacia	Acacia	Redwood Consolidated
Net Interest Income	$ 120	$ 34	$ 154
Operating expenses	(42)		(42)
Realized gains on sales and calls, net	6		6
Market valuation adjustments, net	(44)	(98)	(142)
Net income (loss) before provision for income taxes	40	(64)	(24)
Provision for income taxes	(7)		(7)
Net Income (Loss)	$ 33	$ (64)	$ (31)

The purpose of this pro forma presentation is to show the consolidating components to our income statement and to highlight the negative impact that Acacia had on our consolidated net loss for the three and nine months ended September 30, 2007. While the components reconcile to our consolidated GAAP income statement, this is a non-GAAP presentation. In a GAAP presentation, the Redwood excluding Acacia income statement shown above would have reflected the loss from Acacia.

MTM adjustments on securities can result from a decline in the economic value of the securities (i.e., increased credit loss estimates reduce expected future cash flows), or from changes in market discount rates (i.e., the market requires a greater risk premium and/or interest rates rise), or a combination of both.

Total MTM adjustments taken during the three and nine months ended September 30, 2007 were $757 million and $969 million, respectively. The tables below show the breakdown of these MTM adjustments between Redwood and Acacia. They also detail the amounts that flowed through our income statement and stockholders equity. A summary of the accounting rules regarding MTMs is provided below.

Table 5 Non-GAAP Pro Forma Balance Sheet and Income Statement Information Mark-to-Market Adjustments

	Three Months Ended September 30, 2007		
(In Millions)	Redwood Excluding Acacia	Acacia	Total
Balance Sheet Impact			
Reduction in stockholders' equity	$ (98)	$ (556)	$ (654)

Income Statement Impact			
Market valuation adjustments			
Impairment on AFS securities	(15)	(68)	(83)
Fair value adjustment on trading assets	(3)	(17)	(20)
Total income statement impact	(18)	(85)	(103)
Total Mark-to-Market Adjustments	$ (116)	$ (641)	$ (757)

	Nine Months Ended September 30, 2007		
(In Millions)	Redwood Excluding Acacia	Acacia	Total
Balance Sheet Impact			
Reduction in stockholders' equity	$ (132)	$ (696)	$ (828)
Income Statement Impact			
Market valuation adjustments			
Impairment on AFS securities	(28)	(79)	(107)
Fair value adjustment on trading assets	(15)	(19)	(34)
Total income statement impact	(43)	(98)	(141)
Total Mark-to-Market Adjustments	$ (175)	$ (794)	$ (969)

The purpose of this pro forma presentation is to show the consolidating components for total mark-to-market adjustments for the three and nine months ended September 30, 2007. These mark-to-market adjustments are further detailed by the balance sheet (stockholders equity) and income statement impact. This is a non-GAAP presentation. The total stockholders equity impact of $654 million and $828 million for the three and nine months ended September 30, 2007, respectively, agree to our consolidated statement of comprehensive income for those periods. The total income statement impact of $103 million and $141 million for the three and nine month periods ended September 30, 2007, respectively, agree to our consolidated income statement for those periods.

If the change in fair value for available-for-sale securities (AFS) is due solely to changes in market discount rates, then the entire MTM adjustment is flowed through our balance sheet as an adjustment to stockholders equity. These adjustments can go back and forth (positive or negative) from period to period.

If the change in fair value for AFS is accompanied by an adverse change in projected cash flows, then the entire MTM adjustment is flowed through the income statement. This is required even if the change in projected cash flows is small relative to the resulting MTM income statement charge. We offer the following example: Assume Redwood acquired a security for $100 and the value of this acquisition was based on $150 of future expected cash flows discounted at 12%. If at the end of an accounting period, the market value of the security was $50 and that value was based on $149 of future expected cash flows discounted at 25% (the

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prevailing market rates), the entire $50 change in value is considered permanently impaired for accounting purposes. AFS deemed permanently impaired for accounting purposes cannot be written back up through market valuation adjustments in our income statement. This does not mean the underlying security could not recover in economic or market value. If the economic value of an impaired security does recover, we would recognize this benefit for accounting purposes through a higher interest yield over time. It is often difficult to separate with precision how much of the change in fair value is driven by changes in expected cash flows versus changes in required market discount rates, but during periods of market illiquidity and uncertainty, the market discount rate component can be significant. Therefore, some of our securities classified as permanently impaired for accounting purposes during the third quarter may eventually prove to have significant economic value to us.

All changes in fair value for trading securities or derivative instruments flow through the income statement. These adjustments can be either positive or negative from period to period.

The table below details the total MTM adjustments by the underlying collateral type.

Table 6 Total Mark-to-Market Adjustments By Underlying Collateral Type

	Three Months Ended September 30, 2007				
(In Millions)	IGS	CES	OREI & Derivatives	Total	MTM Percent[1]
Residential					
Prime	$ (82)	$ (131)	$	$ (213)	(16)%
Alt-a	(197)	(67)	(13)	(277)	(22)%
Subprime	(92)	(11)	(5)	(108)	(24)%
Residential total	(371)	(209)	(18)	(598)	
Commercial	(6)	(56)		(62)	(11)%
CDO	(57)	(9)		(66)	(26)%
Interest rate agreements & other			(31)	(31)	
Total Mark-to-Market Adjustments	$ (434)	$ (274)	$ (49)	$ (757)	

	Nine Months Ended September 30, 2007				
(In Millions)	IGS	CES	OREI & Derivatives	Total	MTM Percent[1]
Residential					
Prime	$ (100)	$ (146)	$ 1	$ (245)	(19)%
Alt-a	(234)	(85)	(28)	(347)	(29)%
Subprime	(128)	(18)	(6)	(152)	(32)%
Residential total	(462)	(249)	(33)	(744)	
Commercial	(13)	(101)		(114)	(20)%
CDO	(86)	(11)		(97)	(36)%
Interest rate agreements & other			(14)	(14)	
Total Mark-to-Market Adjustments	$ (561)	$ (361)	$ (47)	$ (969)	

(1) *This percentage represents the MTMs taken as a percentage of the reported market values at the beginning of the period, or purchase price if acquired during the period. It is intended to highlight the price declines by collateral type for the three and nine month periods ended September 30, 2007. These price declines are for our specific portfolio and may not be indicative of price declines in the market in general.*

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Acacia CDO Economics and Accounting Analysis

Economics

Under our Acacia program we re-securitize real estate securities using bankruptcy remote CDO entities that sell ABS (asset backed securities) to independent third party debt investors. We typically retain an equity interest in the Acacia CDOs and receive asset management fees. Our equity investments are entitled to the net cash flows (i.e., the net cash flows generated by the assets after deducting the money owed to the ABS debt holders) of the Acacia entities. Our share of any economic credit losses generated by the underlying Acacia assets are capped for us at the amount of our net equity investment, with the remainder of losses borne by the ABS holders.

As a hypothetical example, an Acacia CDO transaction might have $300 million of assets, $285 million of liabilities (ABS issued), and $15 million of equity. If in any year the assets earned 6% or $18 million, and the ABS were paid interest of 5% or $14.25 million, our equity would be entitled to a distribution of $3.75 million in that year. In certain circumstances, our equity cash distributions can be disrupted based on rating agency down-grades or due to a deterioration in collateral performance.

We have ten Acacia CDO transactions outstanding. Our investment in each of these transactions are separate and independent, thus diminished cash flow generated by any one of our CDO equity investments would have no effect on our other CDO equity investments. During the three and nine months ended September 30, 2007, we collected $5.3 million and $14.6 million, respectively, of cash flow distributions from our Acacia investments. Currently, we are continuing to receive distributions from all Acacias. We are closely monitoring the four Acacia transactions issued since August 2006 as further rating agency down-grades or further deterioration in collateral performance could disrupt cash distributions from these Acacia entities. During the three and nine months ended September 30, 2007, we received cash distributions of $1.5 million and $3.4 million, respectively, from these four Acacia entities (Acacia s 10, 11, 12, and option ARM).

We believe the best measure of economic value for our Acacia equity investment is the net present value of the future cash flow distributions, though we would caution that in this environment it is particularly difficult to predict future cash flows with much certainty given the potential for future rating agency down-grades and the uncertainties around future credit performance and the problems in the housing market that we discussed above. Our calculation of the present value of the future cash flows (adjusted for projected credit losses) from Acacia entities discounted at 45% and 14% range from $55 million to $145 million. Due to the current market illiquidity for CDO equity, we would expect that the fair value of our Acacia investments to be on the lower end of the range rather than the higher end. Our initial cash investment in these Acacia transactions was $140 million. Cumulatively, we have received cash distributions of $27 million on our investments in these Acacia entities. In addition, we received management fees of $8 million.

Accounting

The assets, liabilities, and earnings from the Acacia entities are consolidated for GAAP purposes with Redwood. Over time, the economic and GAAP results of Acacia will be the same. However, there can be interim periods of time when GAAP and economic losses diverge significantly. This results from the fact that under GAAP we are not permitted to adjust the carrying values of our Acacia liabilities until actual losses are passed through to debt holders or the securitization is called (which may not occur for a significant period of time), but we are required to mark-to-market all of the Acacia assets on a quarterly basis. This GAAP accounting treatment resulted in the carrying value of Acacia to be negative $580 million. However, since the economic value of our equity investment cannot be less than zero, our September 30, 2007 consolidated GAAP book value of $149 million understates the value of Acacia by at least $580 million.

The divergence between economic and accounting results is highlighted by Acacia OA (option ARM) in the table below. We made a $14 million cash investment. We have already recognized $20 million of losses through the income statement ($6 million more than our investment). In addition we have further reduced stockholders equity by $149 million for negative MTM adjustments. Thus, our $14 million investment is carried at a $155 million negative book value on our consolidated balance sheet at September 30, 2007.

Table 7 Acacia Balance Sheets

With respect to the four Acacia transactions that currently concern us, our net cash investment as of September 30, 2007 was $66 million. From a GAAP income statement standpoint, we have already collectively recognized losses of $74 million. Therefore, we have already effectively taken $8 million of write-offs through the income statement in excess of these investments.

On January 1, 2008, FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (FAS 159) becomes effective. If adopted by us, FAS 159 will enable us to mark-to-market the Acacia liabilities. We are considering adopting FAS 159 for valuing the assets and liabilities owned by Acacia on January 1, 2008. These rules may allow us to better conform our book value and GAAP income results more closely to what we believe economic reality to be. However, we do not believe the new rules will address all of the related mark-to-market challenges and our reported numbers are likely to remain volatile.

The following table details Acacia s exposure to different collateral types owned by Acacia entities.

Table 8 Acacia Underlying Collateral Type

Mark-to-Market Valuation Process

Our fair market values reflect what we believe we could realize if we chose to sell our securities. However, most of our securities (in particular our CES and CDO investments) are generally illiquid. Consequently, establishing fair market values for these securities is inherently subjective and is dependent upon modeling assumptions and indications of value obtained from brokers or dealers.

As a consequence of limited trading visibility during the quarter and the significant uncertainties regarding credit loss levels, the fair market values underpinning our market valuation adjustments are based on facts that are far less certain than has historically been the case in prior periods. We expect that the market valuations will continue to be highly volatile over time.

To establish fair market values at September 30, 2007, we relied heavily on indications of value (marks) from dealers, and to a lesser extent, on values derived from our internal cash flow modeling. We received third party dealer marks (that may or may not be based on actual trades or their own internal models) on 89% of the number of securities reflected on our balance sheet, and with respect to the remaining 11% for which we did not receive third party dealer marks, we used our internal model to establish fair value.

We compared all of the dealers marks to our internal model for reasonableness. As a result of this process, we accepted some of these marks as an indication of fair value and rejected others. If we rejected the dealer mark, we used our internal model. The table below details the breakdown of internal and external inputs used.

In only 3% of the cases in which we had a third party dealer mark did we value securities above the dealer mark. For these 3%, the difference between the lower dealer marks and our higher internal marks was $9.6 million at September 30, 2007.

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Table 9 Mark-to-Market Valuation Inputs

September 30, 2007		
RWT Internal Model:		
No external dealer marks received	11	%
External Dealer Marks Received:		
External mark accepted	69	%
External mark received but a lower internal mark used	17	%
External mark received but a higher internal mark used	3	%
Total	100	%

Our internal pricing model calculates fair value based on the net present value of projected future cash flows of each individual security. This calculation is dependent on a number of assumptions including: future interest rates, prepayment rates, market discount rates, and timing and amount of future credit losses. The valuation parameters of these models are calibrated to what we believe are bid-side fair market assumptions. The dealers we receive indications from are active participants in capital markets. It is likely that many of the dealer marks we received this period were based on pricing models and not on actual trade information. Their indications of values are based on a variety of assumptions they do not share and may prove to be inaccurate.

Results of Operations

Interest Income

Total interest income consists of interest earned on consolidated earning assets adjusted for amortization of discounts and premiums and provisions for loan credit losses. The table below summarizes interest income earned on real estate loans, real estate securities, other real estate investments, non-real estate investments, and cash.

Table 10 Interest Income and Yield

	Three Months Ended September 30, 2007				Three Months Ended September 30, 2006			
(Dollars in Thousands)	Interest Income	Percent of Total	Average Balance	Yield	Interest Income	Percent of Total	Average Balance	Yield

	Interest Income				Interest Income			
Real estate loans, net of provision for credit losses	$116,670	53.32 %	$7,899,110	5.91 %	$	66.63 %	$9,979,261	5.97 %
Real estate securities	94,776	43.31 %	3,776,850	10.04 %	72,759	32.53 %	2,697,903	10.79 %
Other real estate investments	1,275	0.58 %	31,187	16.36 %				
Non-real estate investments	1,143	0.52 %	80,000	5.71 %				
Cash and cash equivalents	4,960	2.27 %	406,094	4.89 %	1,872	0.84 %	183,323	4.08 %
Total interest income	$218,824	100.00 %	$12,193,241	7.18 %	$223,649	100.00 %	$12,860,487	6.96