REDWOOD TRUST INC
Form 10-K
March 05, 2008

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

FORM 10-K

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

For the Fiscal Year Ended: December 31, 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	68-0329422

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

One Belvedere Place, Suite 300
Mill Valley, California 94941

(Address of Principal Executive Offices) (Zip Code)

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

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 if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

At June 30, 2007, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $1,345,747,756 based on the closing sale price as reported on the New York Stock Exchange.

The number of shares of the registrant s Common Stock outstanding on March 4, 2008 was 32,608,498.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement to be filed with the Securities and Exchange Commission under Regulation 14A within 120 days after the end of registrant s fiscal year covered by this Annual Report are incorporated by reference into Part III.

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REDWOOD TRUST, INC.

2007 FORM 10-K REPORT

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PART I

ITEM 1. BUSINESS

Cautionary Statement

This Annual Report on Form 10-K and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as anticipate, estimate, will, should, expect, believe, intend, seek, plan and similar expressions 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 this Annual Report on Form 10-K 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-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 Annual Report on Form 10-K may contain statistics and other data that in some cases have been obtained from or compiled from information made available by servicers and other third-party service providers.

Redwood Trust, Inc.

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidat subsidiaries, unless the context otherwise requires.

Business Model, Strategy, and Competition

Redwood Trust is a financial institution with competitive advantages in the business of investing in real estate loans and securities. Since Redwood was founded in 1994, our goal has been to create a company that is more efficient than banks, thrifts, insurance companies, and other financial institutions at investing in, financing, and managing residential and commercial real estate loans and securities.

Like many financial institutions, 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 borrowed funds and other liabilities.

Some financial institutions fund their asset investments with borrowed money sourced by taking bank deposits, writing insurance policies, or issuing corporate debt. By contrast, we fund most of our investments with equity. Our investments are sourced from third party issuers of securitizations as well as the two securitization programs we sponsor, Sequoia and Acacia. Sequoia primarily acquires prime residential mortgage loans and creates and issues securities backed by these loans (ABS). Acacia is a collateralized debt obligation (CDO) program that acquires diverse residential and commercial mortgage-backed securities and creates and issues CDO ABS. Most of the securities created and sold by these entities earn the highest credit

rating of AAA, so the interest expense paid out is relatively low compared to lower rated securities. Our investment in the securities we acquire from these entities generally earn the difference in the yield on the securitized assets less the interest expense payments made to the holders of the ABS securities sold. While our investments generally take the first credit losses on the underlying assets, our losses are limited to our investment in each entity.

As a long-term trend, we believe advances in securitization technology have enabled securitization to become increasingly competitive as a funding source relative to corporate debt, deposits, insurance contracts, and other borrowings. With the exception of recent months when capital markets have been in the midst of a liquidity crisis, the cost of funds for ABS securities issued has continued to improve relative to the cost of other borrowings. More importantly, until recently the range of assets that could be efficiently securitized continued to broaden and the capital efficiency of securitization as a source of funding continued to improve. Once the losses inherent in existing ABS are realized and the economy begins to improve, we expect securitization opportunities will return. As global capital markets continue to develop and evolve, we expect securitization to become an even more efficient source of funding in the long-run. There are trillions of dollars of real estate loans and securities in the U.S. and the world, and the amount outstanding has been and is expected to continue to grow every year. We believe many of these assets will be financed more efficiently through securitization than through other means. In addition, we do not believe that there are sufficient deposits in the banking system to fund all the real estate and other assets that require funding, so we believe securitization is a necessary part of our financial system on an on-going basis. Since we provide capital to credit-enhance mortgage loans and securities that are securitized by others and the securitization programs we sponsor, we believe we will be able to continue to grow and diversify our business over the long-term.

We also borrow money on a collateralized and uncollateralized basis, typically at very competitive rates. We do not, however, take deposits or raise money in any other way that would subject us to consumer lending or banking regulations. Since we are not regulated as a financial institution and do not deal directly with consumers, our operating costs are far lower than other financial institutions, and we have far greater freedom to use securitization as a source of funding.

Our tax structure gives us an additional competitive advantage that cannot be easily replicated by most other financial institutions. We have structured our company for tax purposes as a real estate investment trust (REIT) because our primary business is investing in real estate assets. As a REIT, we are required to distribute 90% or more of our taxable income as dividends. By doing so, we avoid paying corporate taxes on most of the income we generate. This lowers our costs, as taxes are one of the largest costs of doing business for most financial institutions.

In terms of capital employed, our largest area of investment is real estate credit-enhancement securities. Typically, 1% to 15% of the principal value of the securities created in a securitization of real estate assets are credit-enhancement securities (CES). These securities bear most of the credit risk with respect to the underlying assets that were securitized. If the underlying loans or securities suffer a loss of principal due to default, that loss is passed on by reducing the principal value of the CES. As a result of the high level of assumed credit risks, CES carry credit ratings that are below investment-grade. Because the CES absorb most or all of the credit risk that would normally be expected to occur, they reduce the credit risk of the more senior securities, allowing them to earn investment-grade ratings and to be sold at higher prices.

We are a leading investor in CES issued from securitizations of prime-quality residential real estate loans and in 2005 and 2006 we were an increasingly important investor in CES issued from securitizations of commercial real estate loans made on income-producing properties. In recent years, we also made small investments in CES issued from securitizations of alt-a and subprime quality residential loans. In 2007, as a result of market conditions, we significantly reduced our level of acquisitions of residential and commercial CES. In total, at December 31, 2007, we owned residential, commercial, and CDO CES with a principal value of $2.5 billion and a market value of $749 million. Many of these securities are deep discount securities where our cost is far less than the principal value. Since we receive interest payments based on the principal value of a CES security, our interest income cash flow returns are strong. In addition, if credit losses are low, we will receive principal payments in excess of our cost basis, thus generating additional investment returns.

Conversely, larger than expected credit losses could rapidly reduce the principal value of our CES, causing our investment returns from CES to suffer.

At December 31, 2007, our CES were first in line to absorb credit losses from $250 billion of residential real estate loans and securities and $62 billion of commercial real estate loans and securities that underlie the securitizations from which our CES investments were issued. However, our potential losses are far smaller and are limited to the purchase price of the CES in our portfolio.

With respect to these CES investments, we have a high degree of structural leverage since the principal value of our CES equals only a small percentage of the underlying asset pools. We do not, however, use a high degree of financial leverage with respect to our CES assets. We use capital (equity plus long-term subordinated debt) rather than debt to finance most of our investments in the more junior subordinated CES (the first-loss and second-loss securities, or equivalent) and we have been using capital plus securitization financing through our Acacia CDO issuance program to finance the more senior CES that are closer to investment-grade quality.

In the near term, we anticipate that our net growth in CES assets will be focused in newly originated prime-quality residential assets and on distressed prime, alt-a, and subprime residential securitizations and CDOs acquired at a substantial discount. Later in 2008, we believe acquisition opportunities in commercial real estate assets may become attractive. We expect to fund these acquisitions with equity capital.

We have begun raising third party capital through a Redwood sponsored opportunity fund that will invest in distressed asset opportunities that we see in the marketplace. Due to the accelerating pace of forced asset sale liquidations, primarily ABS CDO unwinds, we feel that opportunity investments can produce attractive risk adjusted returns for Redwood that supplement our core business initiatives. Our subprime and CDO structuring and investment expertise gives us a competitive advantage in evaluating such distressed asset opportunities. As the Redwood Opportunity Fund, LP manager, we will be entitled to management fees that could become substantial income streams in the future. We allocated $50 million of capital to the Redwood Opportunity Fund, LP during the fourth quarter, and have currently deployed $22 million of this amount into Fund eligible investments. Capital contributions to future opportunity funds will be based upon portfolio diversification, our ability to realize management fee income, and our assessment of risk adjusted returns.

In the second half of 2007, capital markets turmoil increased the cost of issuing mortgage-backed and CDO securities, so our two securitization programs (Acacia and Sequoia) cut back significantly on their purchases and creation of loans and securities. We do not currently anticipate that Acacia will complete any new CDO securitizations in 2008, although it is possible market conditions for these CDO activities could improve towards year-end. We do anticipate Sequoia will acquire loans and issue ABS in 2008, although it is possible that market conditions for these types of securitizations will not improve enough to enable Sequoia to issue any new ABS on a profitable basis.

In 2007, we also acquired AAA-rated investment-grade residential securities with the intention of funding them on an on-going basis with short-term debt. Our goal was to seed the growth of an externally-managed REIT to be managed by Redwood that would pursue this strategy. As the liquidity crisis hit the capital markets in 2007, we sold these securities at a small loss. Going forward, it appears that such an externally-managed REIT may be viable, especially to the extent that assets are largely limited to agency (FNMA and FHLMC) residential mortgage securities. We may seek to develop such a REIT in 2008 or 2009 as part of our strategy of increasing our third-party asset management business.

We buy most of our assets rather than originate them. Our primary strategy for sourcing assets is for us (or the securitization entities we sponsor) to acquire loans and securities directly from other financial institutions or from the capital markets. We do not originate or service loans. Most of the real estate securities we invest in are created by others, some are created by us, but in both cases the underlying loans have been originated by others. This role allows us to have an independent point of view on asset quality and attractiveness, as well as the flexibility to change investment strategies as markets evolve. In our experience over the years, many financial institutions that have origination operations have produced sub-optimal asset investment results. We believe this is because, in some cases, there may have been incentives to retain loans that might not be the best investment (in terms of price and/or quality) in order to maintain or boost

origination volumes and fees. In addition, origination (especially residential loan origination) is a business that is highly cyclical, operations intensive, and increasingly fraught with lender liability. Residential origination is becoming concentrated in the hands of a few large companies that have either banking or brokerage operations as well. Rather than competing with these companies, we develop close relationships with them and help them build their businesses. They need companies like Redwood (and the securitization programs we sponsor) to buy their loans and securities and credit-enhance their securitizations.

We previously built a successful commercial real estate loan origination operation at Redwood, and we may do so again in the future. We may also build a commercial real estate loan special servicing operation. Overall, in the long-run, we intend to build an integrated and diversified commercial real estate investment and specialty finance business. It is not yet clear to us, in light of increasing stress in the commercial real estate markets and the difficult market for commercial real estate CDO financing, what the best model will be for us to pursue with respect to commercial real estate finance in the future. We are in the process of recruiting new management for this business unit. In addition, in order to segregate our commercial business and possibly to finance and brand it separately in the future, we have contributed most of our commercial real estate assets to a wholly-owned subsidiary: Tanoak Commercial Capital Corporation.

We believe our operating efficiencies allow us to remain competitive. In addition, in times like these, when there are few asset buyers and potentially many sellers, and as a result asset prices decline, we benefit competitively from our strong balance sheet, minimal use of Redwood debt, cash balances, and access to new capital. Our competitors are banks, thrifts, insurance companies, Fannie Mae, Freddie Mac, Wall Street brokerage firms, hedge funds, specialty finance companies, mortgage REITs, mortgage insurance companies, CDO securitization managers, asset management companies, foreign investors, and other financial institutions.

Our corporate structure and competitive strengths differ from most other financial institutions. With our differentiated capabilities, we interact as competitors, but also as customers and suppliers, with most of the institutions active in the vast and interconnected real estate capital markets.

We commenced operations in 1994, a period of turmoil in financial markets. This turmoil allowed us to acquire assets that produced very high returns in subsequent years. The level of competition increased dramatically through the end of 1997, at which time we generally sold assets, as the prospective risk/reward relationships for assets did not seem attractive. There were several financial dislocations in 1998, including a prepayment acceleration crisis and a liquidity crisis. This allowed us to use our excess capital to acquire assets, including our own stock, at attractive prices. The CES we acquired in 1999 2002 performed very well, allowing us to report high return on equity results and to pay special dividends of $4.75 per share in 2003 and $6.00 per share in 2004.

As the financial markets experience turmoil due to falling housing prices and rising residential loan defaults, we are and will increasingly incur increased credit losses but we are also in a good position to take advantage of the lower asset prices that have resulted. We believe competition for distressed asset acquisition opportunities will increase, however, but we also believe the magnitude and duration of extraordinary asset acquisition opportunities for the next year or two could be large relative to the supply of funds available to acquire these assets.

Through our internal risk-adjusted capital policies, we seek to maintain a strong balance sheet with a large capital base, risks that are limited and segregated, and ample liquidity.

We use capital, not debt, to fund assets such as first-loss credit-enhancement securities that carry concentrated credit risks. These assets have a high degree of structural credit risk, so we do not feel it would be prudent to employ financial leverage to acquire these assets. Our risk is limited to our investment in these securities. Since we fund these assets with capital rather than debt, high credit losses should not cause liquidity concerns.

We consolidate the assets and liabilities of Sequoia and Acacia. For these entities, our economic risk is limited to the value of any securities we may acquire as an investment from these entities. Our liquid reserves are secure with respect to these securitized assets consolidated on our balance sheet, since the assets were acquired by independent securitization entities, whose liabilities are not Redwood s obligations. Typically, we fund securities acquired from securitizations we sponsor with capital or we sell these securities to another securitization entity for re-securitization. In either case, the risk is segregated and limited.

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We have used Redwood debt to fund assets, and we may do so in the future. In the current environment, we expect to use capital (equity plus long-term subordinated debt) to fund most of our assets.

With respect to interest rate and prepayment rate risks, we seek to maintain a balance sheet that is well balanced and that can generate cash flows to fund our regular dividend in a wide variety of scenarios. We believe we have achieved this the net present value of our projected cash flows does not vary materially with respect to scenarios incorporating changes in interest rates or prepayment rates. Scenarios incorporating different degrees of potential credit losses, however, show a wide variation in the long-term net present value of our cash flows. In the near-term (one to three years), our results may vary as a function of changes in interest rates, prepayments, credit results, mark to-market asset values, and other factors.

Our primary financial goal is to distribute the highest levels of dividends per share over the next few decades as we can. We seek to do that while also remaining within our risk tolerance levels and while increasing the inherent value of the company by building competitive advantages, diversifying risks and opportunities, developing internal capabilities, maintaining our culture, keeping operations highly efficient, and increasing book value per share over time.

As a REIT, we are required to distribute to our shareholders as dividends at least 90% of our REIT profits as calculated for tax purposes. We distribute our profits as a regular quarterly dividend and also, in some years, in a year-end special dividend. The regular dividend rate for 2007 was $0.75 per share per quarter and the special dividend was $2.00 per share. Total dividends for 2007 were $5.00 per share.

We expect the regular dividend to be $0.75 per share per quarter for 2008, maintaining the same rate as in 2007. We set the regular dividend at a rate low enough so that we believe there is a relatively small chance that we would need to reduce it in the next few years. Whether we pay a special dividend or not in 2008 will depend primarily on how much REIT taxable income we generate during the year. We expect our total annual dividend payout amounts (regular plus special) will vary from year to year.

Profitable growth is our mission. In a manner consistent with our goal of distributing dividends per share in attractive amounts over time, our mission is to grow to become a larger company in terms of capital employed and market capitalization. We are targeting growth by building real estate investment, financing, and management operations with competitive advantages. Over the long term, growth should bring several advantages, including book value accretion and a diversified income stream.

We plan to grow organically as markets grow and as we gain long-term market share, rather than simply growing for growth s sake or through short-term acquisition of market share, which would be irresponsible and inconsistent with our long-term goal of distributing attractive dividends per share. But we do not expect growth to be linear, because in cyclical markets growth is not always the appropriate short-term strategy.

Information Concerning Redwood Trust

Our website can be found at www.redwoodtrust.com. We make available, free of charge on or through our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after those materials are filed with, or furnished to, the SEC. We also make available, free of charge, access to our Code of Ethics, Corporate Governance Standards, Audit Committee Charter, Compensation Committee Charter, and Governance and Nominating Committee Charter.

Certifications

Our Chief Executive Officer and Chief Financial Officer have executed certifications dated March 4, 2008, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, and we have included those certifications as exhibits to our Annual Report on Form 10-K for the year ended December 31, 2007. In addition, our Chief Executive Officer certified to the New York Stock Exchange (NYSE) on June 11, 2007 that he is unaware of any violations by Redwood Trust, Inc. of the NYSE s corporate governance listing standards in effect as of that date.

Employees

As of December 31, 2007, Redwood employed 99 people.

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ITEM 1A. RISK FACTORS

The following is a summary of the risk factors that we believe are most relevant to our business. These are factors which, individually or in the aggregate, we think could cause our actual results to differ significantly from anticipated or historical results. In addition to understanding the key risks described below, investors should understand that it is not possible to predict or identify all risk factors, and consequently, the following is not a complete discussion of all potential risks or uncertainties. We undertake no obligation to update forward-looking statements, whether as a result of new information, future events, or otherwise. Investors are advised, however, to consult any further disclosure we make in our reports on Forms 10-Q and 8-K filed with the SEC.

Risks Related to our Business

Residential and commercial real estate loan delinquencies, defaults, and credit losses could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.

We assume credit risk with respect to residential and commercial real estate loans primarily through the ownership of credit-enhancement securities (CES) backed by residential and commercial real estate loans, collateralized debt obligation (CDO) CES backed by residential and commercial securities, and through residential and commercial real estate loans. Residential and commercial CES have below investment-grade credit ratings and, correspondingly, a high degree of credit risk with respect to the residential and commercial real estate loans within the securitizations that issued these securities. We also assume credit risk through the residential, commercial, and CDO investment grade securities (which we refer to collectively as IGS) we own.

Credit losses on residential real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; increases in payments required to be made by borrowers; declines in the value of homes; earthquakes and other natural events; over-leveraging of the borrower; changes in legal protections for lenders; and personal events affecting borrowers, such as reduction in income, job loss, divorce or health problems. If the U.S. economy or the housing market continue to weaken, our credit losses could increase beyond levels that we originally anticipated or anticipate.

Rising interest rates may increase the credit risks associated with residential real estate loans. The interest rate is adjustable for most of the loans securitized by securitization entities we have sponsored and for a portion of the loans underlying residential and CDO CES we have acquired from securitizations sponsored by others. Accordingly, when short-term interest rates rise, required monthly payments from homeowners will rise under the terms of these adjustable-rate mortgages, and this may increase borrowers delinquencies and defaults.

Credit losses on commercial real estate loans can occur for many of the reasons noted above for residential real estate loans. Losses on commercial real estate loans can also occur for other reasons including decreases in the net operating income from the underlying property, which could be adversely affected by a weakened U.S. economy. Moreover, many commercial real estate loans are not fully amortizing and, therefore, the borrower s ability to repay the principal when due may depend upon the ability of the borrower to refinance or sell the property at maturity. Additional risks associated with commercial real estate loans are discussed below.

The IGS we hold also have credit-related risks. These assets initially received investment-grade ratings, but these initial ratings do not ensure that these securities will be free from credit losses, especially in a housing or economic downturn.

We attempt to manage these risks by periodically evaluating our investments for impairment indicators and establishing reserves for credit and other risks based upon our assessment of these risks. However, the amount of capital and cash reserves that we hold to help us manage credit and other risks may prove to be insufficient to protect us from earnings volatility, reductions or suspensions in regular dividends, and liquidity issues. If these increased credit losses are greater than we anticipated and we need to increase our credit reserves or in the event that assets which have declined in value are deemed to be other-than-temporarily

impaired, our GAAP earnings might be reduced. Increased credit losses may also adversely affect our cash flows, dividend distribution requirements and payments, asset fair values, access to short-term borrowings, and our ability to securitize assets.

The nature of the securities we hold exposes us to concentrated credit risk that could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.

Our residential and commercial CES have concentrated risks with respect to residential and commercial real estate loans, respectively. In general, losses on an asset securing a residential or commercial real estate loan included in a securitization will be borne first by the owner of the property (i.e., the owner will first lose the equity invested in the property) and, thereafter, by a cash reserve fund or letter of credit, if any, then by the first-loss CES holder, and then by holders of more senior CES. In the event the losses incurred upon default on the loan exceed any equity support, reserve fund, letter of credit, and classes of securities junior to those in which we invest (if any), we will not be able to recover all of our principal investment in the securities we hold. In addition, if the underlying properties have been overvalued by the originating appraiser or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related ABS, then the first-loss securities may suffer a total loss of principal, followed by losses on the second-loss and then third-loss securities (or other residential and commercial CES or residential and commercial IGS) in which we invest (or have an indirect interest), which have effectively become the first-loss position behind the more senior securities.

The nature of the assets underlying some of the securities we hold could increase the credit risk of those securities, which, in turn, could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.

For certain types of loans underlying our CES, the loan rate or borrower payment rate may increase over time, increasing the potential for default. For example, a portion of the securities we acquire, or have an indirect interest in through our investment in the Acacia entities we sponsor (sometimes collectively referred to as Acacia), are backed by residential real estate loans that have negative amortization features. The rate at which interest accrues on these loans may change more frequently or to a greater extent than payment adjustments on an adjustable-rate loan, and adjustments of monthly payments may be subject to limitations or may be limited by the borrower s option to pay less than the full accrual rate. As a result, the amount of interest accruing on the remaining principal balance of the loans at the applicable adjustable mortgage loan rate may exceed the amount of the monthly payment. This is particularly a risk in a rising interest rate environment. Negative amortization occurs when the resulting excess is added to the unpaid principal balance of the related adjustable mortgage loan. For certain loans that have a negative amortization feature, the required monthly payment is increased after a specified number of months or after a maximum amount of negative amortization has occurred in order to amortize fully the loan by the end of its original term. Other negative amortizing loans limit the amount by which the monthly payment can be increased, which results in a larger final payment at maturity. As a result, negatively amortizing loans have performance characteristics similar to those of balloon loans. Negative amortization may result in increases in delinquencies, loan loss severity, and loan defaults, which may, in turn, result in payment delays and credit losses on our investments. Other types of loans to which we are exposed, such as hybrid loans and teaser-rate adjustable-rate loans, may also have greater credit risk than more traditional mortgage loans.

We credit-enhance commercial real estate loans and hold commercial CES, which may have significant credit and other risks that could adversely affect our business and operating results.

The commercial real estate assets we own or in which we have an indirect interest through our investment in Acacia entities may be subject to significant credit and other risks, including environmental and legal risks. The net operating income and fair values of commercial real estate properties may fluctuate with economic cycles and as a result of other factors, so that debt service coverage may be unstable. The value of the property may not support the value of the loan if there is a default. Commercial real estate loans are particularly sensitive to changes in the local economy, so even minor local adverse economic events may adversely affect the performance of commercial real estate assets. Many commercial real estate loans are not fully amortizing and, therefore, the timely recovery of principal is dependent on the borrower s ability to refinance or sell the property at maturity.

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The prices of commercial CES are more sensitive to adverse economic downturns or individual issuer developments than more highly rated real estate securities. A projection of an economic downturn, for example, could cause a decline in the price of commercial CES because of increasing concerns regarding the ability of obligors of loans underlying ABS to continue to make principal and interest payments.

For some types of loans in which we have had an economic interest in the past and may again in the future, the commercial real estate is in transition, such as a former office building that is in the process of being converted into condominiums. These loans entail higher risks than traditional commercial property loans made against stabilized properties. Initial debt service coverage ratios, loan-to-value ratios, and other indicators of credit quality for these loans may not meet standard market criteria for stabilized commercial real estate loans. The underlying properties may not transition or stabilize as expected. The personal guarantees and forms of cross-collateralization that are secured in connection with some of these loans may not be effective. In addition, we own some mezzanine loans that are not secured by a direct lien on the underlying property.

Our commercial loans are illiquid; if we choose to sell them, we may not be able to do so in a timely manner or for a satisfactory price. Financing these loans may be difficult, and may become more difficult if credit quality deteriorates.

Mezzanine loans, distressed assets, and loan participations have concentrated credit, servicing, and other risks. We have in the past directly originated some of our commercial loans and participated in the origination of others, and may do so again in the future. This may expose us to credit, legal, and other risks that may be greater than is usually present with acquired loans.

The nature of the assets underlying some of the securities we hold couldincrease the credit risk of those securities, We may incur losses on commercial real estate loans and securities for reasons not necessarily related to an adverse change in the performance of the property. This includes bankruptcy by the owner of the property, issues regarding the form of ownership of the property, poor property management, origination errors, inaccurate appraisals, fraud, and non-timely actions by special servicers. We review the underlying loan files prior to acquiring residential and commercial CES but our review may not uncover these or other issues at that time. By the time these problems become apparent, we may have little or no recourse to the issuer of the securities and we may incur losses as a result.

The timing of credit losses can harm our economic returns.

The timing of credit losses can be a material factor in our economic returns from residential and commercial loans and securities. If unanticipated losses occur within the first few years after a loan is originated or a securitization is completed, those losses could have a greater negative impact on our investment returns than unanticipated losses on more mature loans or securities. In addition, higher levels of delinquencies and cumulative credit losses within a securitized loan pool can delay our receipt of the principal and interest that is due to us under the terms of the securities backed by that pool. This would also lower our economic returns.

The timing of credit losses could be affected by new legislation or legal actions that allow for the modification of loans. It is difficult to anticipate what, if any, changes to underlying loans would be allowed and to determine the impact on these changes to ultimate credit losses or changes in interest income on our investments.

The securities and loans we own are likely to lead to variable returns.

We actively manage the risks associated with acquiring, holding, and disposing of real estate loans and securities. No amount of risk management or mitigation, however, can change the variable nature of the cash flows, fair values of, and financial results generated by these loans and securities. Changes in the credit performance or the prepayments on these real estate loans and the loans underlying these securities and changes in interest rates impact the cash flows on these securities, and the impact could be significant for our securities with concentrated risks. Changes in cash flows lead to changes in our return and also to potential variability in reported income. The revenue recognized on most of our assets is based on an estimate of the yield over the remaining life of the asset. Thus, changes in our estimates of expected cash flow from an asset will result in changes in our reported earnings on that asset. We may be forced to recognize adverse changes

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in expected future cash flows as a current expense, further adding to earnings volatility. For other assets and some liabilities, our revenue and income is affected by changes in the fair value of our assets and liabilities, which may further accentuate our earnings volatility.

For other assets, our revenue and income, if any, are based on changes in the fair value of the asset. As market conditions, liquidity, perceptions, supply and demand, and the fundamentals of each asset change, the fair values can vary widely, causing volatility in our reported earnings. Fair values for illiquid assets can be difficult to ascertain accurately, which may also lead to volatility and uncertainty of earnings.

Changes in the fair values of our assets and liabilities can have various negative effects on us, reduced earnings, increased earnings volatility, and volatility in our book value.

Fair values for our assets, liabilities, and hedges can be volatile. The fair values can change rapidly and significantly and changes can result from changes in interest rates, perceived risk, supply and demand, projected cash flows and prepayments and credit performance.

A decrease in fair value may not necessarily be the result of a deterioration in future cash flows. For GAAP purposes, we mark-to-market some, but not all, of our consolidated assets and liabilities through our consolidated balance sheet. In addition, valuation adjustments on certain assets and many of our derivatives are reflected in our consolidated statement of income. As a result, assets that are funded with certain liabilities and interest-rate matched with certain liabilities and hedges may have differing mark-to-market treatment than the liability or hedge. If we sell an asset that has not been marked to market through our consolidated statement of income at a reduced market price relative to its basis, our reported earnings will be reduced.

A decrease in the fair value of the securities we own may result in a reduction in our book value due to the accounting standards we are required to apply, and could result in a negative book value. Reporting a low or negative book value could have adverse effects even if that the book value is not indicative of the actual value of our net investments in assets and securitization entities. The adverse effects include the inability to meet or agree upon covenants with counterparties or to enter into derivative contracts, and a reduction in the market price of our stock.

Effective January 1, 2008, we adopted a new accounting standard, Financial Accounting Standards Board Statement No. 159 *The Fair Value Option for Financial Assets and Financial* (FAS 159), which allows us to MTM both the consolidated assets and liabilities of Acacia. FAS 159 provides for a one-time cumulative-effect adjustment to retained earnings on the balance sheet on January 1, 2008 for the unrealized gains or losses on Acacia assets and liabilities at that time. We expect the adoption of FAS 159 will reduce the magnitude of the disparity that existed between the value of Acacia under GAAP presentation and the economic value of Acacia at December 31, 2007. Even following the adoption of FAS 159, however, there will likely be significant differences between the value of Acacia under GAAP presentation and the economic value of Acacia. Discrepancies arise as a result of market dynamics and the limitations of the measurement techniques required by FAS 159. In addition to affecting our GAAP balance sheet, the adoption of FAS 159 with respect to the Acacia assets and liabilities will also affect our income statements, as we will be required to record any net changes in the fair value those assets and liabilities in any given period. Fair values for illiquid assets can be difficult to ascertain accurately, which may lead to volatility and uncertainty of earnings. Moreover, on January 1, 2008, the fair values of the Acacia liabilities used for GAAP purposes were, in our view, depressed relative to the paired collateral asset values. If the fair values of these liabilities were to increase, these changes would appear on our GAAP income statements as negative MTM adjustments.

Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and increased earnings volatility.

Changes in interest rates, the interrelationships between various interest rates, and interest rate volatility could have negative effects on our earnings, the fair value of our assets and liabilities, loan prepayment rates, and our access to liquidity. Changes in interest rates can also harm the credit performance of our assets. We seek to hedge some but not all interest rate risks. Our hedging may not work effectively, or we may change our hedging strategies or the degree or type of interest rate risk we assume.

A portion of our equity-funded assets have adjustable-rate coupons. The cash flows we receive from these assets may vary as a function of interest rates, as do the GAAP earnings generated by these assets. We also own debt-funded loans and securities which we hold as inventory prior to sale to a securitization entity or as a longer term investment. We fund these assets with equity and with floating rate debt. To the extent these assets have fixed or hybrid interest rates (or are adjustable with an adjustment period longer than our short-term debt), an interest rate mismatch exists and we will earn less (and fair values may decline) if interest rates rise. We usually, but not always, seek to mitigate interest rate mismatches for these assets with a hedging program using interest rate swaps and futures.

Interest rate changes have diverse and sometimes unpredictable effects on the prepayment rates of real estate loans. Changes in prepayment rates can lower the returns we earn from our assets, diminish or delay our cash flows, reduce the fair value of our assets, and decrease our liquidity.

Except with respect to our adjustable-rate assets, higher interest rates generally reduce the fair value of most of our assets. This may affect our earnings results, reduce our ability to re-securitize or sell our assets, or reduce our liquidity. Higher interest rates could reduce the ability of borrowers to make interest payments or to refinance their loans. Higher interest rates could reduce property values and increased credit losses could result. Higher interest rates could reduce mortgage originations, thus reducing our opportunities to acquire new assets, and possibly driving asset acquisition prices higher.

When short-term interest rates are high relative to long-term interest rates, an increase in adjustable-rate residential loan prepayments may occur, which would likely reduce our returns from owning adjustable-rate residential whole loans.

If short-term interest rates fall, our premium amortization expense will increase on loans acquired by Sequoia prior to July 2004, which are reported on our consolidated balance sheet. Due to the GAAP principle applied to these adjustable-rate loans, the amortization expense for the current period is a function of actual and projected prepayments and the current LIBOR interest rate. During a period of rapidly falling rates, the effect that the interest rate has on the amortized amount becomes the more significant factor and will increase the amount amortized thereby decreasing our reported income for that period, all other factors being equal.

Credit ratings of debt securities may not accurately reflect the risks associated with those debt securities.

Rating agencies rate debt securities based upon their assessment of the safety of the receipt of principal and interest payments. Rating agencies do not consider the risks of fluctuations in fair value or other factors that may influence the value of debt securities and, therefore, the assigned credit rating may not fully reflect the true risks of an investment in securities. Also, rating agencies may fail to make timely adjustments to initial credit ratings based on recently available data or changes in economic outlook or may otherwise fail to make changes in credit ratings in response to subsequent events, so that our investments may be better or worse than the ratings indicate. We try to reduce the impact of the risk that a credit rating may not accurately reflect the risks associated with a particular debt security by not relying solely on credit ratings as the indicator of the quality of an investment. We make our acquisition decisions after factoring in other information. However, our assessment of the quality of an investment may also prove to be inaccurate and we may incur credit losses in excess of our initial expectations.

Credit rating agencies may change their methods of evaluating credit risk and determining ratings on securities backed by real estate loans and securities. These changes may occur quickly and often. The market s ability to understand and absorb these changes, and the impact to the securitization market in general, are difficult to predict. Such changes will have an impact on the amount securities that will be available to us either by the level of securitization and the various sizes of the investment-grade and non-investment-grade securities that are created in the future.

Further downgrades in the credit ratings of bond insurers or any downgrades in the credit ratings of mortgage insurers could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business and operations.

Some of the securities held by us through our Acacia entities as well some of the securities held by us at Redwood are insured by bond insurers such as Ambac Financial Group Inc., MBIA Inc, and Financial Guaranty Insurance Co., which are commonly known as the monoline insurers. These monoline insurers historically have had AAA credit ratings and this credit rating has been passed on to any bonds that they