REDWOOD TRUST INC
Form 10-Q
November 05, 2012
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UNITED STATES OF AMERICA

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)**

OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: September 30, 2012

OR

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

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

Commission File Number 1-13759

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland	**68-0329422**

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

One Belvedere Place, Suite 300

Mill Valley, California	**94941**
(Address of Principal Executive Offices)	(Zip Code)

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

Not Applicable

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

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

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

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

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

Common Stock, $0.01 par value per share	81,522,712 shares outstanding as of November 2, 2012

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REDWOOD TRUST, INC.

2012 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, 2012	December 31, 2011
ASSETS		
Residential loans (includes $377,393 and $2,169 at fair value)	$ 3,494,562	$ 4,194,885
Commercial loans (includes $12,150 and $12,129 at fair value)	298,220	169,855
Real estate securities, at fair value	1,312,347	981,837
Cash and cash equivalents	39,384	267,176
Total earning assets	5,144,513	5,613,753
Restricted cash	42,546	14,987
Accrued interest receivable	16,079	15,840
Derivative assets	3,424	2,373
Deferred securities issuance costs	6,284	8,083
Other assets	84,009	88,262
Total Assets (1)	$ 5,296,855	$ 5,743,298
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$ 522,214	$ 428,056
Accrued interest payable	6,494	8,134
Derivative liabilities	108,555	127,564
Accrued expenses and other liabilities	41,233	8,105
Asset-backed securities issued (includes $255,411 and $209,381 at fair value)	3,429,007	4,139,355
Long-term debt	139,500	139,500
Total liabilities (1)	4,247,003	4,850,714
Equity		
Common stock, par value $0.01 per share, 125,000,000 shares authorized; 81,526,321 and 78,555,908 issued and outstanding	815	786
Additional paid-in capital	1,739,841	1,697,979
Accumulated other comprehensive income (loss)	73,872	(13,151)
Cumulative earnings	590,974	501,283
Cumulative distributions to stockholders	(1,355,650)	(1,294,313)

Total equity		1,049,852		892,584
Total Liabilities and Equity	$	5,296,855	$	5,743,298

(1) Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At September 30, 2012 and December 31, 2011, assets of consolidated VIEs totaled $3,718,551 and $4,408,350, respectively, and liabilities of consolidated VIEs totaled $3,486,728 and $4,209,124, respectively. See *Note 4* for further discussion.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
(Unaudited)				
Interest Income				
Residential loans	$ 20,419	$ 20,192	$ 65,041	$ 57,564
Commercial loans	7,482	2,353	18,363	5,379
Real estate securities	31,805	30,845	94,532	97,703
Cash and cash equivalents	17	6	52	38
Total interest income	59,723	53,396	177,988	160,684
Interest Expense				
Short-term debt	(2,737)	(78)	(6,863)	(267)
Asset-backed securities issued	(23,171)	(21,855)	(73,827)	(62,526)
Long-term debt	(2,377)	(2,384)	(7,132)	(7,130)
Total interest expense	(28,285)	(24,317)	(87,822)	(69,923)
Net Interest Income	31,438	29,079	90,166	90,761
Provision for loan losses	(1,319)	(3,978)	(254)	(8,367)
Other market valuation adjustments	(2,263)	(12,365)	(7,661)	(25,164)
Other-than-temporary impairments (1)	(1,207)	(1,083)	(1,842)	(5,171)
Other market valuation adjustments, net	(3,470)	(13,448)	(9,503)	(30,335)
Net Interest Income After Provision and Other Market Valuation Adjustments	26,649	11,653	80,409	52,059
Mortgage banking activities, net	16,730	-	22,743	-
Operating expenses	(17,102)	(11,507)	(46,900)	(35,107)
Realized gains, net	13,940	1,145	34,555	10,844
Net income before provision for income taxes	40,217	1,291	90,807	27,796
Provision for income taxes	(516)	(14)	(1,116)	(42)
Net income	39,701	1,277	89,691	27,754
Less: Net loss attributable to noncontrolling interest	-	(20)	-	(1,147)
Net Income Attributable to Redwood Trust, Inc.	$ 39,701	$ 1,297	$ 89,691	$ 28,901
Basic earnings per common share	$ 0.48	$ 0.01	$ 1.10	$ 0.35
Diluted earnings per common share	$ 0.48	$ 0.01	$ 1.09	$ 0.35
Regular dividends declared per common share	$ 0.25	$ 0.25	$ 0.75	$ 0.75
Basic weighted average shares outstanding	79,685,099	78,470,625	78,908,057	78,275,796
Diluted weighted average shares outstanding	80,764,380	78,470,625	80,175,660	78,275,796

(1) For the three months ended September 30, 2012, other-than-temporary impairments were $1,580 of which $373 were recognized in Accumulated Other Comprehensive Income. For the three months ended September 30, 2011, other-than-temporary impairments were $1,372, of which $289 were recognized in Accumulated Other Comprehensive Income.

For the nine months ended September 30, 2012, other-than-temporary impairments were $2,472 of which $630 were recognized in Accumulated Other Comprehensive Income. For the nine months ended September 30, 2011, other-than-temporary impairments were $7,339, of which $2,168 were recognized in Accumulated Other Comprehensive Income.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
(Unaudited)				
Net Income	$ 39,701	$ 1,297	$ 89,691	$ 28,901
Other comprehensive income:				
Net unrealized gain (loss) on available-for-sale securities	41,392	(12,366)	83,467	(42,885)
Reclassification of other-than-temporary impairments to net income	796	957	1,210	3,306
Net unrealized gain (loss) on interest rate agreements	2,346	(37,970)	(914)	(39,498)
Reclassification of unrealized loss on interest rate agreements to net income	1,126	1,067	3,260	3,211
Total other comprehensive income (loss)	45,660	(48,312)	87,023	(75,866)
Total comprehensive income (loss)	85,361	(47,015)	176,714	(46,965)
Less: Comprehensive income attributable to noncontrolling interest	-	-	-	4,164
Comprehensive Income (Loss) Attributable to Redwood Trust, Inc.	$ 85,361	$ (47,015)	$ 176,714	$ (51,129)

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

For the Nine Months Ended September 30, 2012

(In Thousands, Except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Noncontrolling Interest	Total
December 31, 2011	78,555,908	$ 786	$ 1,697,979	$ (13,151)	$ 501,283	$ (1,294,313)	$ -	$ 892,584
Net income	-	-	-	-	89,691	-	-	89,691
Other comprehensive income	-	-	-	87,023	-	-	-	87,023
Issuance of common stock:								
Dividend reinvestment & stock purchase plans	2,609,151	26	36,398	-	-	-	-	36,424
Employee stock purchase and incentive plans	361,262	3	(1,905)	-	-	-	-	(1,902)
Non-cash equity award compensation	-	-	7,369	-	-	-	-	7,369
Common dividends declared	-	-	-	-	-	(61,337)	-	(61,337)
September 30, 2012	81,526,321	$ 815	$ 1,739,841	$ 73,872	$ 590,974	$ (1,355,650)	$ -	$ 1,049,852

For the Nine Months Ended September 30, 2011

(In Thousands, Except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Noncontrolling Interest	Total
December 31, 2010	78,124,668	$ 781	$ 1,689,851	$ 112,339	$ 474,940	$ (1,213,158)	$ 10,839	$ 1,075,592
Net income (loss)	-	-	-	-	28,901	-	(1,147)	27,754
Other comprehensive (loss) income	-	-	-	(80,030)	-	-	4,164	(75,866)
Issuance of common stock:								
Dividend reinvestment & stock purchase plans	310,146	3	4,580	-	-	-	-	4,583
Employee stock purchase and incentive plans	282,458	3	(2,857)	-	-	-	-	(2,854)
Non-cash equity award compensation	-	-	6,764	-	-	-	-	6,764
Share repurchases	(222,386)	(2)	(2,696)	-	-	-	-	(2,698)
Distributions to noncontrolling interest, net	-	-	-	-	-	-	(14,112)	(14,112)
Common dividends declared	-	-	-	-	-	(60,474)	-	(60,474)
Deconsolidation elimination	-	-	-	-	-	-	256	256
September 30, 2011	78,494,886	$ 785	$ 1,695,642	$ 32,309	$ 503,841	$ (1,273,632)	$ -	$ 958,945

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, Except Share Data)	**Nine Months Ended September 30,**	
(Unaudited)	**2012**	**2011**
Cash Flows From Operating Activities:		
Net income attributable to Redwood Trust, Inc.	$ 89,691	$ 28,901
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(18,045)	(24,618)
Depreciation and amortization of non-financial assets	1,727	768
Purchases of loans - mortgage banking	(1,522,949)	-
Proceeds from sales of loans - mortgage banking	1,128,232	-
Principal payments on loans - mortgage banking	7,438	-
Net settlements of derivatives - mortgage banking	(20,376)	-
Provision for loan losses	254	8,367
Non-cash equity award compensation	7,369	6,764
Market valuation adjustments, net	4,489	30,335
Realized gains, net	(52,003)	(10,844)
Net change in:		
Accrued interest receivable	(1,359)	(1,405)
Deferred tax asset	-	3,487
Other assets	6,897	(31,672)
Accrued interest payable	14,180	11,301
Accrued expenses and other liabilities	12,278	(5,892)
Net cash (used in) provided by operating activities	(342,177)	15,492
Cash Flows From Investing Activities:		
Purchases of loans	(135,662)	(724,950)
Proceeds from sales of loans [(1)]	388,507	1,857
Principal payments on loans	425,344	282,126
Purchases of real estate securities	(445,277)	(90,512)
Proceeds from sales of real estate securities	172,265	86,254
Principal payments on real estate securities	173,849	129,838
Proceeds from deconsolidation	6,386	-
Net (decrease) increase in restricted cash	(27,600)	7,513
Net cash provided by (used in) investing activities	557,812	(307,874)
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	1,043,767	-
Repayments on short-term debt	(949,609)	(44,137)
Proceeds from issuance of asset-backed securities	2,445	884,771
Repayments on asset-backed securities issued	(491,134)	(350,246)
Deferred securities issuance costs	-	(4,598)
Net settlements of derivatives	(20,047)	(30,291)
Net proceeds from (payments for) issuance of common stock	32,488	(967)
Dividends paid	(61,337)	(60,382)
Change in noncontrolling interests	-	(15,259)
Net cash (used in) provided by financing activities	(443,427)	378,891

Net (decrease) increase in cash and cash equivalents		(227,792)		86,509
Cash and cash equivalents at beginning of period		267,176		46,937
Cash and cash equivalents at end of period	$	39,384	$	133,446
Supplemental Disclosures:				
Cash paid for interest	$	89,727	$	55,809
Cash paid for taxes		225		48
Dividends declared but not paid at end of period		-		19,624
Transfers from residential loans to real estate owned		4,825		8,418

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate-related assets. We seek to invest in assets that have the potential to generate sufficient cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time. We also seek to generate fee and gain on sale income primarily through mortgage banking activities conducted at certain of our subsidiaries.

The assets we primarily invest in are (i) residential mortgage loans, (ii) commercial mortgage loans and other forms of commercial real estate financing (which we generally refer to as commercial loans), and (iii) securities collateralized by mortgage loans or other real estate-related debt.

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2012 and December 31, 2011, and for the three and nine months ended September 30, 2012 and 2011. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States of America as prescribed by the Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) and using the Securities and Exchange Commission s (SEC) instructions to Form 10-Q.

Organization

For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust (REIT). Our consolidated financial statements include the accounts of Redwood, its direct and indirect wholly-owned subsidiaries, and other entities in which we have a controlling financial interest. All significant intercompany balances and transactions have been eliminated. Redwood s consolidated subsidiaries include both qualifying REIT subsidiaries and taxable subsidiaries. References to the REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

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

Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. We currently consolidate the assets and liabilities of the Sequoia and the Acacia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during 2011 (Resecuritization). Prior to the fourth quarter of 2011, we also consolidated the assets, liabilities, and noncontrolling interests of the Opportunity Fund (Fund) that we managed. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 2. Basis of Presentation (continued)

For financial reporting purposes, the underlying loans and securities owned at the Sequoia entities, Acacia entities, and Resecuritization entity are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The asset-backed securities (ABS) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned at these entities and interest expense on the ABS issued by these entities. We also recorded interest income on the securities owned at the Fund and any income attributable to noncontrolling interest holders during prior periods.

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

Note 3. Summary of Significant Accounting Policies

Use of Estimates

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

Fair Value Measurements

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

- Quoted prices for the same or similar securities;
- Relevant reports issued by analysts and rating agencies;
- The current level of interest rates and any directional movements in relevant indices, such as credit risk indices;
- Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;

Indicative prices or yields from broker/dealers; and,

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

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

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

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Fair Value Option

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

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

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

Residential and Commercial Loans

Residential and Commercial Loans Fair Value

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

Residential and Commercial Loans Held-for-Sale

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

Residential and Commercial Loans Held-for-Investment

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

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

Residential Loans Allowance for Loan Losses

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

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

- Ongoing analyses of loans, including, but not limited to, the age of loans and year of origination, underwriting standards, business climate, economic conditions, and other observable data;
- Historical loss rates and past performance of similar loans;
- Relevant environmental factors;
- Relevant market research and publicly available third-party reference loss rates;
- Trends in delinquencies and charge-offs;
- Effects and changes in credit concentrations;
- Information supporting a borrower s ability to meet obligations;

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

Discounted cash flow analyses.

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

As part of the loss mitigation efforts undertaken by servicers of residential loans owned by Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal amounts owed on a mortgage loan; and, (iv) extension of the contractual maturity of a mortgage loan. We evaluate all loan modifications performed by servicers to determine if they constitute troubled debt restructurings (TDRs) according to GAAP. If a loan is determined to be a TDR, it is removed from the general loan pools used for calculating allowances for loan losses and assessed for impairment on an individual basis based upon any adverse change in the expected future cash flows resulting from the modification. This difference is recorded to the reversal of (provision for) loan losses in our consolidated statements of income.

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Commercial Loans Allowance for Loan Losses

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

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

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

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

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

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

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

Based on the assigned impairment status, a loan is categorized as Pass, Watch List, or Workout. Pass loans are defined as loans that are performing in accordance with the contractual terms of the loan agreement. Watch List loans are defined as performing loans for which the timing of cost recovery is under review. Workout loans are defined as loans that we believe have a credit impairment that may lead to a realized loss. Workout loans are typically assessed for impairment on an individual basis. Where an individual commercial loan is impaired, we record an allowance to reduce the carrying value of the loan to the current present value of expected future cash flows discounted at the loan s effective rate, with a corresponding charge to our consolidated statement of income.

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

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

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

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

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

Repurchase Reserves

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Real Estate Securities, at Fair Value

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

Trading Securities

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

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

AFS Securities

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

For an AFS security where its estimated fair value at the reporting date is below its amortized cost basis, we evaluate the security for other-than-temporary impairment (OTTI). If we either (i) intend to sell the impaired security; (ii) will more likely than not be required to sell the impaired security before it recovers in value; or, (iii) do not expect to recover the impaired security s amortized cost basis even if we do not intend to sell the security the impairment is deemed an OTTI and we record the entire difference between the security s fair value and its amortized cost in our consolidated statements of income. Conversely, if none of these three conditions is met, we analyze the expected cash flows, or cost recovery of the security, to determine what, if any, OTTI is recognized through our consolidated statements of income. This analysis includes an assessment of any changes in the regulatory and/or economic environment that might affect the performance of the security.

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less. At September 30, 2012, we did not have any significant concentrations of credit risk arising from cash deposits as all of our cash and cash equivalents were invested in FDIC-insured bank products.

Restricted Cash

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities. Restricted cash may also include cash retained in the Acacia or Sequoia securitization entities or in the resecuritization entity prior to the payments on or redemptions of outstanding ABS issued. At September 30, 2012, we did not have any significant concentrations of credit risk arising from restricted cash deposits as all of our restricted cash was held in custodial accounts or FDIC-insured bank products.

Accrued Interest Receivable

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

Derivative Financial Instruments

Derivative financial instruments we currently utilize include contractual interest rate agreements, financial futures contracts, and To Be Announced (TBA) contracts. All derivative financial instruments are recorded at fair value in our consolidated balance sheets. Derivatives with positive fair values to us are reported as assets and derivatives with negative fair values to us are reported as liabilities. We classify each of our derivative financial instruments as either (i) a trading instrument (no specific hedging designation for financial reporting purposes) or (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

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

We will discontinue cash flow hedge accounting if (i) we determine that the hedging derivative is no longer expected to be effective in offsetting changes in the cash flows of the designated hedged item; (ii) the derivative expires or is sold, terminated, or exercised; (iii) the derivative is de-designated as a cash flow hedge; or, (iv) it is probable that a forecasted transaction associated with the hedged item will not occur by the end of the originally specified time period. To the extent we de-designate a cash flow hedging relationship and the associated hedged item continues to exist, any unrealized gain or loss of the cash flow hedge at the time of de-designation remains in accumulated other comprehensive income and is amortized using the straight-line method through interest expense over the remaining life of the hedged liability.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Interest Rate Agreements

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

Eurodollar Futures, Treasury Futures, and TBA Contracts

Eurodollar futures are futures contracts on time deposits denominated in U.S. dollars at banks outside the United States. Eurodollar futures, unlike our other derivatives, have maturities of only three months. Therefore, in order to achieve the desired interest rate offset necessary to manage our risk, consecutively maturing contracts are required, resulting in a stated notional amount that is typically higher than our other derivatives. Treasury futures are futures contracts on benchmark U.S. Treasury rates. TBA contracts are forward contracts to purchase mortgage-backed securities that will be issued by a U.S. government sponsored enterprise (GSE) in the future. We purchase or sell these derivatives to offset to varying degrees changes in the values of mortgage products for which we have exposure.

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

Deferred Tax Assets

Our deferred tax assets are generated by temporary differences in GAAP and taxable income at our taxable subsidiaries. These differences generally reflect differing accounting treatments for tax and GAAP, such as accounting for discount and premium amortization, credit losses, equity awards, asset impairments, and certain valuation estimates. As a result of these differences, we may recognize taxable income in periods prior to when we recognize income for GAAP. When this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is reduced. We did not have a deferred tax asset at September 30, 2012 or December 31, 2011.

Deferred Securities Issuance Costs

Securities issuance costs are expenses associated with the issuance of long-term debt, the resecuritization we engaged in during 2011, and the ABS from the Sequoia securitization entities we sponsor and consolidate for financial reporting purposes. These expenses typically include underwriting, rating agency, legal, accounting, and other fees. ABS issuance costs associated with liabilities accounted for under the fair value option are expensed as incurred. ABS issuance costs associated with liabilities reported at cost are deferred. Deferred securities issuance costs are reported on our consolidated balance sheets as deferred charges (an asset) and are amortized as an adjustment to interest expense using the interest method, based upon the actual and estimated repayment schedules of the related securities issued.

Other Assets

Other assets include REO, mortgage servicing rights (MSRs), margin receivable, fixed assets, principal receivable, and other prepaid expenses.

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

MSRs

We recognize MSRs through the acquisition of servicing rights released by third parties or through the retention of MSRs associated with residential loans that we have acquired and subsequently transferred to third parties. Typically, our MSRs are directly acquired from loan originators or created through the transfer of loans to a Sequoia residential mortgage securitization sponsored by us that meets the GAAP criteria for sale accounting.

Our MSRs are held and managed at Redwood Residential Acquisition Corporation, a wholly-owned subsidiary of RWT Holdings, Inc., which is a taxable REIT subsidiary of ours. MSRs are initially recognized and carried at their estimated fair values. Changes in the fair value of MSRs are reported in mortgage banking activities, net, a component of our consolidated statements of income.

See *Note 17* for further discussion on MSRs.

Short-Term Debt

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

See *Note 11* for further discussion on short-term debt.

Accrued Interest Payable

Accrued interest payable includes interest that is due and payable to third parties. Interest is generally paid within one to three months of recording the payable, based upon our remittance requirements. For borrowings where we have elected the fair value option, the associated accrued interest on these liabilities is measured at fair value. For financial liabilities where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represents ABS issued by bankruptcy-remote entities sponsored by Redwood. Sequoia, Acacia, and the resecuritization assets are held in the custody of securitization trustees and are not owned by Redwood. These trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the ABS investors.

Sequoia ABS Issued

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

Acacia ABS Issued

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

Resecuritization ABS Issued

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

See *Note 12* for further discussion on ABS issued.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Long-Term Debt

Long-term debt includes trust preferred securities and subordinated notes and is carried at its unpaid principal balance. Our long-term debt is unsecured with quarterly interest payments determined based upon a floating rate equal to the three-month London Interbank Offered Rate (LIBOR) plus a margin until it is redeemed in whole or matures at a future date.

See *Note 13* for further discussion on long-term debt.

Equity

Accumulated Other Comprehensive Income

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements designated as cash flow hedges are reported as components of accumulated other comprehensive income on our consolidated statements of changes in equity and our statements of consolidated comprehensive income. Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive income are adjusted for the effects of taxation and may create deferred tax assets or liabilities.

Noncontrolling Interest

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

Earnings Per Common Share

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

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

See *Note 15* for further discussion on equity.

Incentive Plans

In May 2012, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided for an increase in the number of shares available for distribution under the plan. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock options (ISOs), non-qualifying stock options (NQSOs), performance stock units (PSUs), deferred stock units (DSUs), restricted stock, performance shares, performance units, stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a three- or four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

The cost of equity awards is determined in accordance with share-based payment accounting guidance and amortized over the vesting term using an accelerated method for equity awards granted prior to December 1, 2008. For equity awards granted after December 1, 2008, the cost of the awards is amortized over the vesting period on a straight-line basis. Timing differences between the accelerated and straight-line methods of amortization were determined to not be material to our consolidated financial statements.

Employee Stock Purchase Plan

In May 2012, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP) to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in the Company through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter.

Executive Deferred Compensation Plan

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

401(k) Plan

We offer a tax-qualified 401(k) Plan to all employees for retirement savings. Under this Plan, employees are allowed to defer and invest up to 100% of their cash earnings, subject to the maximum 401(k) Plan contribution limit set forth by the Internal Revenue Service. We match some employee contributions to encourage participation and to provide a retirement planning benefit to employees. Vesting of the 401(k) Plan matching contributions is based on the employee s tenure at the Company, and over time, an employee becomes increasingly vested in both prior and new matching contributions.

See *Note 16* for further discussion on equity compensation plans.

Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. To qualify as a REIT we must distribute at least 90% of our annual REIT taxable income to shareholders (not including taxable income retained in our taxable subsidiaries) within the time frame set forth in the tax code and also meet certain other requirements related to assets, income, and stock ownership. We assess our tax positions for all open tax years and determine whether we have any material unrecognized liabilities in accordance with FASB guidance on accounting for uncertainty in income taxes. We record these liabilities to the extent we deem them incurred. We classify interest and penalties on material uncertain tax positions as interest expense and operating expense, respectively, in our consolidated statements of income.

See *Note 19* for further discussion on taxes.

Note 4. Principles of Consolidation

GAAP requires us to consider whether securitizations and other transfers of financial assets should be treated as sales or financings, as well as whether any VIEs for example, certain legal entities often used in securitization and other structured finance transactions should be included in our consolidated financial statements. The GAAP principles we apply require us to reassess our requirement to consolidate VIEs each quarter and therefore our determination may change based upon new facts and circumstances pertaining to each VIE. This could result in a material impact to our consolidated financial statements during subsequent reporting periods.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 4. Principles of Consolidation (continued)

Analysis of Consolidated VIEs

The VIEs we are required to consolidate include certain Sequoia and Acacia securitization entities and the Resecuritization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of ours, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

Assets and Liabilities of Consolidated VIEs at September 30, 2012

September 30, 2012 (Dollars in thousands)	Sequoia Entities	Acacia Entities	Resecuritization	Total
Residential loans, held-for-investment	$ 3,076,580	$ -	$ -	$ 3,076,580
Commercial loans, at fair value	-	12,150	-	12,150
Real estate securities, at fair value	-	243,072	325,226	568,298
Restricted cash	342	42,104	-	42,446
Accrued interest receivable	6,502	1,733	883	9,118
Derivative assets	-	909	-	909
Deferred securities issuance costs	4,244	-	832	5,076
Other assets	3,919	55	-	3,974
Total Assets	$ 3,091,587	$ 300,023	$ 326,941	$ 3,718,551
Accrued interest payable	$ 3,051	$ 1,713	$ 44	$ 4,808
Derivative liabilities	-	52,584	-	52,584
Accrued expenses and other liabilities	101	228	-	329
Asset-backed securities issued	2,994,636	255,411	178,960	3,429,007
Total Liabilities	$ 2,997,788	$ 309,936	$ 179,004	$ 3,486,728
Noncontrolling interest	$ -	$ -	$ -	$ -
Number of VIEs	34	9	1	44

We consolidate the assets and liabilities of certain Sequoia securitization entities, as we did not meet the GAAP sale criteria at the time we transferred financial assets to these entities. Our involvement in consolidated Sequoia entities continues in the following ways: (i) we continue to hold subordinate investments in each entity, and for certain entities, more senior investments; (ii) we maintain certain discretionary rights associated with our sponsorship of, or subordinate investments in, each entity; and, (iii) we continue to hold a right to call the assets of certain entities (once they have been paid down below a specified threshold) at a price equal to, or in excess of, the current outstanding principal amount of the entity s asset-backed securities issued. These factors have resulted in our continuing to consolidate the assets and liabilities of these Sequoia entities in accordance with ASC 860-10.

We consolidate the assets and liabilities of the Acacia entities, as we did not meet the GAAP sale criteria at the time we transferred financial assets to these entities. Our involvement in these entities continues in the following ways: (i) we continue in the role of collateral manager for all but one Acacia entity; (ii) we continue to hold a right to call the assets of each entity at a price equal to, or in excess of, the current outstanding principal amount of the entity s asset-backed securities issued; and (iii) we continue to hold subordinate investments, and in some cases, more senior investments in each entity. These factors have resulted in our continuing to consolidate the assets and liabilities of the Acacia entities in accordance with ASC 860-10. However, our role as collateral manager has, under the terms of the applicable management agreements, been significantly curtailed or eliminated with respect to the Acacia entities, many of which have experienced an event of default. In addition, the estimated fair values of our call rights and investments in the Acacia entities have significantly diminished, or been effectively eliminated, over time.

We consolidate the assets and liabilities of the Resecuritization entity as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity s inception and design. We transferred residential senior residential securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold them to CSMC 2011-9R, the Resecuritization entity. In connection with this transaction, we acquired certain senior and subordinate securities that we continue to hold. We engaged in this resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our senior residential securities portfolio.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 4. Principles of Consolidation (continued)

During the first quarter of 2012, we sold variable interests in certain Sequoia securitization entities issued between 2001 and 2003 and determined that upon completion of an accounting analysis we should derecognize the associated assets and liabilities of these secured borrowings for financial reporting purposes. We deconsolidated $307 million of residential loans and other assets and $307 million of ABS issued and other liabilities, and after giving effect to all other accounting entries, we recorded a realized gain of $7 million on our consolidated statement of income for the three months ended March 31, 2012. These gains were comprised of both recoveries of provisions for loan losses that exceeded our recorded investment in these entities as well as cash raised from the sale of our investment interests. We maintained our intent to hold our economic interests in all remaining consolidated Sequoia entities at September 30, 2012.

During the third quarter of 2012, one of the Acacia entities was liquidated at the direction of the senior note holders. As a result of this liquidation, $8 million of trading securities were sold and $470 million of ABS issued (principal balance) was extinguished. After giving effect to all other accounting entries, we recorded a net positive market valuation adjustment of $1 million on our consolidated statement of income for the three months ended September 30, 2012.

Analysis of Unconsolidated VIEs with Continuing Involvement

During the nine months ended September 30, 2012, we transferred residential loans to four Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes, in accordance with ASC 860. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer, we recorded MSRs on our consolidated balance sheet at September 30, 2012, and classified those MSRs as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets.

The following table presents information related to the Sequoia securitization transactions that occurred during the three and nine months ended September 30, 2012.

Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

(Dollars in Thousands)	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Principal balance of loans transferred	$ 313,226	$ 1,350,082
Trading securities retained, at fair value	5,139	31,925
AFS securities retained, at fair value	18,576	75,293
Gains on sale	4,023	15,632
MSRs recognized	1,241	3,849

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

Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

(Dollars in Thousands)	**Three Months Ended September 30, 2012**	**Nine Months Ended September 30, 2012**
Cash proceeds	$ 299,582	$ 1,271,655
MSR fees received	233	371
Funding of servicing advances	27	27
Cash flows received on retained securities	2,333	5,432

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Note 4. Principles of Consolidation (continued)

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

MSR Assumptions Related to Unconsolidated VIEs Sponsored by Redwood

At Date of Securitization	Issued During Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Prepayment speeds	5 - 28 %	5 - 23 %
Discount rates	12 %	10 %

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

Unconsolidated VIEs Sponsored by Redwood at September 30, 2012

(Dollars in Thousands)	September 30, 2012
On-balance sheet assets, at fair value	
Interest-only securities, classified as trading	$ 6,301
Subordinate securities, classified as AFS	78,244
Maximum loss exposure [1]	84,545
Principal balance of loans outstanding	1,233,017

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

The following table presents key economic assumptions and the sensitivity of the current fair value to immediate adverse changes in those assumptions at September 30, 2012.

Key Assumptions and Sensitivity Analysis for Unconsolidated VIEs Sponsored by Redwood

September 30, 2012 (Dollars in Thousands)	MSRs	Senior Interest-only Securities	Subordinate Securities
Fair value at September 30, 2012	$ 2,655	$ 6,301	$ 78,244
Expected weighted-average life (in years)	2	3	12
Prepayment speed assumption (annual CPR)	32 %	30 %	18 %
Decrease in fair value from:			
10% adverse change	$ 206	$ 479	$ 415
25% adverse change	476	1,103	942
Discount rate assumption	12 %	21 %	6 %
Decrease in fair value from:			
100 basis point increase	$ 53	$ 87	$ 6,809
200 basis point increase	105	171	12,777
Credit loss assumption	N/A	0.48 %	0.47 %
Decrease in fair value from:			
10% higher losses	N/A	$ 4	$ 419
25% higher losses	N/A	9	1,048

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 4. Principles of Consolidation (continued)

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities for which we maintain an economic interest but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interest in third-party VIEs at September 30, 2012, grouped by collateral type and ownership interest.

Third-Party VIE Summary

September 30, 2012 **(Dollars in Thousands)**		**Fair Value**	**Number of VIEs**
Real estate securities at Redwood			
Residential			
Senior	$	427,995	36
Re-REMIC		149,973	15
Subordinate		73,853	138
Commercial		7,619	6
CDO		64	6
Total Third-Party Real Estate Securities	$	659,504	201

We determined that we are not the primary beneficiary of any third-party residential, commercial, or CDO entities, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs we only account for our specific interests in them.

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

Note 5. Fair Value of Financial Instruments

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at September 30, 2012 and December 31, 2011.

	September 30, 2012		December 31, 2011	
(In Thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, at fair value	$ 370,035	$ 370,035	$ -	$ -
Residential loans, held-for-sale	47,947	49,921	395,237	401,909
Residential loans, held-for-investment	3,076,580	2,756,005	3,799,648	3,306,441
Commercial loans, at fair value	12,150	12,150	12,129	12,129
Commercial loans, held-for-investment	286,070	288,658	157,726	158,780
Trading securities	272,925	272,925	253,142	253,142
Available-for-sale securities	1,039,422	1,039,422	728,695	728,695
Cash and cash equivalents	39,384	39,384	267,176	267,176
Restricted cash	42,546	42,546	14,987	14,987
Accrued interest receivable	16,079	16,079	15,840	15,840
Derivative assets	3,424	3,424	2,373	2,373
Mortgage servicing rights (1)	2,655	2,655	-	-
REO (1)	3,919	5,093	5,669	8,161
Margin receivable (1)	66,814	66,814	71,976	71,976
Liabilities				
Short-term debt	522,214	522,214	428,056	428,056
Accrued interest payable	6,494	6,494	8,134	8,134
Derivative liabilities	108,555	108,555	127,564	127,564
ABS issued	3,429,007	3,074,969	4,139,355	3,467,054
Long-term debt	139,500	80,910	139,500	57,195

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

We elected the fair value option for $5 million and $36 million of residential senior securities that we acquired during the three and nine months ended September 30, 2012, respectively. We have historically elected the fair value option for all commercial loans, trading securities, and ABS issued at Acacia entities, as well as certain third-party residential securities and CDOs. In the third quarter of 2012, we also elected the fair value option for $524 million of residential loans we acquired. We anticipate electing the fair value option for all future purchases of residential loans that we intend to sell to third parties or transfer to Sequoia securitizations.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2012

September 30, 2012 (In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3
Assets				
Residential loans, at fair value	$ 370,035	$ -	$ -	$ 370,035
Commercial loans, at fair value	12,150	-	-	12,150
Trading securities	272,925	-	-	272,925
Available-for-sale securities	1,039,422	-	-	1,039,422
Derivative assets	3,424	-	3,424	-
MSRs	2,655	-	-	2,655
Liabilities				
Derivative liabilities	108,555	618	90,687	17,250
ABS issued - Acacia	255,411	-	-	255,411

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the nine months ended September 30, 2012.

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

	Assets					Liabilities	
(In Thousands)	Residential Loans	Commercial Loans	Trading Securities	AFS Securities	MSRs	Derivative Liabilities	ABS Issued - Acacia
Beginning balance - December 31, 2011	$ -	$ 12,129	$ 253,142	$ 728,695	$ -	$ 19,500	$ 209,381
Transfer to Level 3	-	-	-	-	-	-	-
Principal paydowns	(727)	(113)	(66,403)	(107,446)	-	-	(42,877)
Gains (losses) in net income, net	15,433	134	75,912	49,257	(1,194)	3,394	73,193
Unrealized gains in OCI, net	-	-	-	84,677	-	-	-
Acquisitions	524,038	-	35,389	430,737	3,849	-	-

Sales	(168,624)	-	(25,657)	(146,608)	-	-	-
Other settlements, net	(85)	-	542	110	-	(5,644)	15,714
Ending Balance - September 30, 2012	$ 370,035	$ 12,150	$ 272,925	$ 1,039,422	$ 2,655	$ 17,250	$ 255,411

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at both September 30, 2012 and 2011. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and nine months ended September 30, 2012 and 2011 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at September 30, 2012 and 2011 Included in Net Income

	Included in Net Income Three Months Ended September 30,		Included in Net Income Nine Months Ended September 30,	
(In Thousands)	2012	2011	2012	2011
Assets				
Residential loans, at fair value	$ 11,662	$ -	$ 11,662	$ -
Commercial loans, at fair value	11	(184)	134	1,358
Trading securities	28,937	(5,207)	71,136	(3,938)
Available-for-sale securities	(1,207)	(1,083)	(1,842)	(3,551)
Derivative assets	-	-	-	-
Mortgage servicing rights	(578)	-	(1,029)	-
Liabilities				
Derivative liabilities	(2,304)	1,651	(3,394)	1,651
ABS issued - Acacia	(28,167)	16,530	(73,193)	9,773

The following table presents information on assets recorded at fair value on a non-recurring basis at September 30, 2012. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at September 30, 2012.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at September 30, 2012

September 30, 2012		Fair Value Measurements Using			Gain (Loss) Three Months Ended	Gain (Loss) Nine Months Ended
(In Thousands)	Carrying Value	Level 1	Level 2	Level 3	September 30, 2012	September 30, 2012
Assets						

Residential loans, held-for-sale	$ 7,358	$ -	$ -	$ 7,358	$ (355)	$ (310)
REO	919	-	-	919	(146)	(175)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 5. Fair Value of Financial Instruments (continued)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the three and nine months ended September 30, 2012 and 2011.

Market Valuation Adjustments, Net

(In Thousands)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Other market valuation adjustments				
Residential loans, held-for-sale	$ 90	$ 363	$ 572	$ 374
Commercial loans, at fair value	11	(184)	134	1,358
Trading securities	30,672	(5,359)	75,822	4,963
Impairments on AFS securities	(1,207)	(1,083)	(1,842)	(5,171)
REO	(220)	(255)	(364)	(1,416)
Other derivative instruments, net	(4,649)	(23,460)	(10,632)	(40,216)
ABS issued - Acacia	(28,167)	16,530	(73,193)	9,773
Total other market valuation adjustments, net	(3,470)	(13,448)	(9,503)	(30,335)
Mortgage banking activities market valuation adjustments				
Residential loans, at fair value	14,976	-	14,992	-
MSRs	(650)	-	(1,194)	-
Derivative instruments, net	(2,385)	-	(8,784)	-
Total mortgage banking activities market valuation adjustments, net	11,941	-	5,014	-
Total Market Valuation Adjustments, Net	$ 8,471	$ (13,448)	$ (4,489)	$ (30,335)

Valuation Policy

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

Valuation Process

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

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

Fair Value Methodology for Level 3 Financial Instruments

September 30, 2012 (In Thousands)	**Fair Value**	**Unobservable Input**	**Range**	**Weighted Average**
Assets				
Residential loans, at fair value	$ 370,035	Discount rate	2 - 3 %	3 %
		Prepayment rate	15 - 15 %	15 %
Residential loans, held-for-sale	7,358	Loss severity	5 - 31 %	9 %
Commercial loans, at fair value	12,150	Discount rate	12 - 14 %	13 %
		Debt coverage ratio	1.52 - 1.61	1.54
		Occupancy	86 - 91 %	87 %
Trading and AFS securities	1,312,347	Discount rate	5 -20 %	7 %
		Prepayment speed	2 - 55 %	12 %
		Default rate	1 - 77 %	18 %
		Loss severity	20 - 100 %	48 %
		Credit support	0 - 96 %	8 %
MSRs	2,655	Discount rate	12 - 12 %	12 %
		Prepayment rate	14 - 60 %	32 %
REO	919	Historical loss adjustment	20 - 35 %	28 %
Liabilities				
Derivative liabilities	17,250	Collateral cash-flow	N/A	N/A
	255,411	Discount rate	5 - 20 %	10 %

ABS issued - Acacia			
	Prepayment speed	2 - 55 %	7 %
	Default rate	1 - 77 %	32 %
	Loss severity	20 - 100 %	59 %

Determination of Fair Value

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 5. Fair Value of Financial Instruments (continued)

Residential loans

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

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

Commercial loans

Estimated fair values for commercial loans are determined by both market comparable pricing and discounted cash flow analysis valuation techniques (Level 3). The availability of market quotes for our commercial loans is limited. Any changes in fair value are primarily a result of instrument specific credit risk. Our discounted cash flow models utilize certain significant unobservable inputs including prepayment rate and debt coverage ratio assumptions. An increase in these unobservable inputs will reduce the fair value of the commercial loans and alternatively, a decrease in these inputs would result in the commercial loans increasing in value.

Real estate securities

Real estate securities include residential, commercial, CDO, and other asset-backed securities that are generally illiquid in nature and trade infrequently. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. Relevant market indicators that are factored into the analyses include bid/ask spreads, credit losses, interest rates, and prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. The fair value of our securities would generally decrease in value based upon an increase in serious delinquencies. Conversely, the fair value of our securities would generally increase if the prepayment rate or credit support inputs were to increase.

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at September 30, 2012, we received dealer price indications on 56% of our securities. In the aggregate, our internal valuations of the securities for which we received dealer price indications were 1% lower than the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Derivative assets and liabilities

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

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Note 5. Fair Value of Financial Instruments (continued)

For other derivatives, valuations are based on various factors such as liquidity, bid/offer spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management s best estimate is used (Level 3). At September 30, 2012, derivative instruments classified as Level 3 consisted of certain interest rate swaps held at our Acacia securitization entities. These derivatives are only entitled to cash flows generated from assets held within their respective securitization entity. Consequently, to the extent that the value of the estimated cash flows of the assets within the entity is less than the estimated fair value of the derivative, an adjustment to the carrying value of the derivative is made. Any change in estimated cash flows of assets within a securitization entity that result in the value of those cash flows being less than the estimated fair value of the derivative will result in an adjustment to the carrying value of the derivative.

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

MSRs

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

REO

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

Margin receivable

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

Short-term debt

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

ABS issued

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 5. Fair Value of Financial Instruments (continued)

As part of our ABS issued valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at September 30, 2012, we received dealer price indications on 55% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were 8% higher (i.e., more conservative) than the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Long-term debt

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

Note 6. Residential Loans

We acquire residential loans from third-party originators. During the three and nine months ended September 30, 2012, we purchased $519 million and $1.51 billion (principal balance), respectively, of residential loans primarily in connection with our Sequoia securitization program. During the third quarter of 2012, we elected the fair value option for all residential loans we acquired, and anticipate doing so for most future purchases of residential loans as well. The following table summarizes the classifications and carrying value of the residential loans owned at Redwood and at consolidated Sequoia entities at September 30, 2012 and December 31, 2011.

September 30, 2012 **(In Thousands)**	**Redwood**	**Sequoia**	**Total**
Fair value	$ 370,035	$ -	$ 370,035
Held-for-sale	47,947	-	47,947
Held-for-investment	-	3,076,580	3,076,580
Total Residential Loans	$ 417,982	$ 3,076,580	$ 3,494,562

December 31, 2011 **(In Thousands)**	**Redwood**	**Sequoia**	**Total**
Fair value	$ -	$ -	$ -
Held-for-sale	395,237	-	395,237

Held-for-investment		-		3,799,648		3,799,648
Total Residential Loans	$	395,237	$	3,799,648	$	4,194,885

We do not currently service any residential loans, although at September 30, 2012, we did own MSRs that provided us with the rights to service $299 million (principal balance) of consolidated residential loans purchased from third-party originators.

Residential Loans at Fair Value

At September 30, 2012, there were 429 residential loans at fair value, with an aggregate outstanding principal balance of $354 million and an aggregate fair value of $370 million. During the three months ended September 30, 2012, we recorded $15 million of positive valuation adjustments on these residential loans through mortgage banking activities, net, a component of our consolidated income statement.

Residential Loans Held-for-Sale

At September 30, 2012, there were 59 residential loans held-for-sale with $49 million in outstanding principal balance and a lower of cost or fair value of $48 million. During the three months ended September 30, 2012 and 2011, we recorded valuation adjustments for residential loans held-for-sale of negative $367 thousand and positive $363 thousand, respectively. During the nine months ended September 30, 2012 and 2011, we recorded positive valuation adjustments for residential loans held-for-sale of $131 thousand and $374 thousand, respectively. At December 31, 2011, loans held-for-sale had an outstanding principal value of $395 million and a lower of cost or fair value of $395 million.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 6. Residential Loans (continued)

Residential Loans Held-for-Investment

The following table details the carrying value for residential loans held-for-investment at September 30, 2012 and December 31, 2011. These loans are owned at Sequoia securitization entities that we consolidate for financial reporting purposes.

(In Thousands)	September 30, 2012	December 31, 2011
Principal balance	$ 3,099,411	$ 3,829,847
Unamortized premium, net	30,917	36,682
Recorded investment	3,130,328	3,866,529
Allowance for loan losses	(53,748)	(66,881)
Carrying Value	$ 3,076,580	$ 3,799,648

Of the $3.1 billion of principal balance and $31 million of unamortized premium on loans held-for-investment at September 30, 2012, $1.1 billion of principal balance and $19 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the first nine months of 2012, 6% of these residential loans prepaid and we amortized 12% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal balance was $2 billion and the unamortized premium was $12 million. During the first nine months of 2012, 15% of these loans prepaid and we amortized 11% of the premium. During the first quarter of 2012, we derecognized $308 million of loan principal balance and $1 million of unamortized premium related to the deconsolidation of five Sequoia securitization entities.

Of the $3.8 billion of principal balance and $37 million of unamortized premium on loans held-for-investment at December 31, 2011, $1.5 billion of principal balance and $23 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal balance was $2.3 billion and the unamortized premium was $14 million.

Credit Characteristics of Residential Loans Held-for-Investment

As a percentage of our recorded investment, 98% of residential loans held-for-investment at September 30, 2012, were first lien, predominately prime-quality loans at the time of origination. The remaining 2% of loans were second lien, home equity lines of credit. The weighted average original LTV ratio for our residential loans held-for-investment outstanding at September 30, 2012, was 66%. The weighted average FICO score for the borrowers of these loans was 736 at the time the loans were originated.

We consider the year of origination of our residential loans held-for-investment to be a general indicator of credit performance as loans originated in specific years have often possessed similar product and credit characteristics. The following table displays our recorded investment in residential loans held-for-investment at September 30, 2012 and December 31, 2011, organized by year of origination.

(In Thousands)	September 30, 2012	December 31, 2011
2003 & Earlier	$ 1,341,583	$ 1,771,111
2004	982,888	1,045,815
2005	126,202	129,163
2006	175,047	181,017
2007	56,062	63,301
2008	-	-
2009	74,508	144,116
2010	237,785	343,278
2011	136,253	188,728
Total Recorded Investment	$ 3,130,328	$ 3,866,529

Allowance for Loan Losses on Residential Loans

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

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(Unaudited)

Note 6. Residential Loans (continued)

Activity in the Allowance for Loan Losses on Residential Loans

The following table summarizes the activity in the allowance for loan losses for the three and nine months ended September 30, 2012 and 2011.

(In Thousands)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Balance at beginning of period	$ 55,449	$ 62,306	$ 66,881	$ 62,432
Charge-offs, net	(2,514)	(2,287)	(7,653)	(6,802)
Provision for (reversal of provision for) loan losses	813	3,978	(902)	8,367
Deconsolidation adjustment	-	-	(4,578)	-
Balance at End of Period	$ 53,748	$ 63,997	$ 53,748	$ 63,997

During the three months ended September 30, 2012 and 2011, there were $3 million and $2 million of charge-offs, respectively, of residential loans that reduced our allowance for loan losses. These charge-offs arose from $7 million and $8 million of defaulted loan principal, respectively. During the nine months ended September 30, 2012 and 2011, there were $8 million and $7 million of charge-offs, respectively, of residential loans that reduced our allowance for loan losses. These charge-offs arose from $21 million and $23 million of defaulted loan principal, respectively.

Residential Loans Collectively Evaluated for Impairment

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

The following table summarizes the balances for loans collectively evaluated for impairment at September 30, 2012 and December 31, 2011.

(In Thousands)	September 30, 2012	December 31, 2011
Principal balance	$ 3,082,581	$ 3,815,010
Recorded investment	3,114,381	3,852,455
Related allowance	51,019	64,069

The following table summarizes the recorded investment and past due status of residential loans collectively evaluated for impairment at September 30, 2012 and December 31, 2011.

(In Thousands)	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Current	Total Loans
September 30, 2012	$ 43,549	$ 19,672	$ 113,879	$ 2,937,281	$ 3,114,381
December 31, 2011	58,954	20,938	135,671	3,636,892	3,852,455

Residential Loans Individually Evaluated for Impairment

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for qualifying borrowers and potentially reduce a future impairment. For the nine months ended September 30, 2012 and 2011, all of the loan modifications determined to be TDRs were either: (i) conversions of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reductions in the contractual interest rates of a mortgage loan paired with capitalization of accrued interest; or (iii) principal forgiveness paired with interest rate reductions.

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(Unaudited)

Note 6. Residential Loans (continued)

The following table presents the details of the loan modifications determined to be TDRs for the three and nine months ended September 30, 2012 and 2011.

(Dollars in Thousands)	Three Months Ended September 30, 2012	2011	Nine Months Ended September 30, 2012	2011
TDRs				
Number of modifications	4	5	10	11
Pre-modification outstanding recorded investment	$ 1,337	$ 2,297	$ 3,848	$ 5,706
Post-modification outstanding recorded investment	1,397	2,245	3,823	5,543
Loan modification effect on Net Interest Income After Provision and Other MVA	(410)	(446)	(1,007)	(911)
TDRs that Subsequently Defaulted				
Number of modifications	2	1	6	2
Recorded investment	$ 1,301	$ 710	$ 2,987	$ 1,244

If we determine that a restructured loan is a TDR, we remove it from the general loan pools used for determining the allowance for residential loan losses and assess it for impairment on an individual basis. This assessment is based primarily on whether an adverse change in the expected future cash flows resulted from the restructuring. The average recorded investment of loans individually evaluated for impairment for the three months ended September 30, 2012 and 2011, was $16 million and $11 million, respectively. For the three months ended September 30, 2012 and 2011, we recorded $22 thousand and $168 thousand interest income, respectively, on individually impaired loans. The average recorded investment of loans individually evaluated for impairment for the nine months ended September 30, 2012 and 2011, was $15 million and $12 million, respectively. For the nine months ended September 30, 2012 and 2011, we recorded $281 thousand and $337 thousand interest income, respectively, on individually impaired loans.

The following table summarizes the balances for loans individually evaluated for impairment, all of which had an allowance, at September 30, 2012 and December 31, 2011.

(In Thousands)	September 30, 2012	December 31, 2011
Principal balance	$ 16,830	$ 14,837
Recorded investment	15,947	14,074
Related allowance	2,729	2,812

The following table summarizes the recorded investment and past due status of residential loans individually evaluated for impairment at September 30, 2012 and December 31, 2011.

(In Thousands)	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Current	Total Loans
September 30, 2012	$ 2,855	$ 993	$ 1,696	$ 10,403	$ 15,947
December 31, 2011	768	2,222	2,026	9,058	14,074

Note 7. Commercial Loans

We invest in commercial loans that we originate and service as well as loans that we acquire from third-party originators. Some of these loans are financed through the Acacia entities that we sponsor. The following table summarizes the classifications and carrying value of commercial loans at September 30, 2012 and December 31, 2011.

September 30, 2012

(In Thousands)	Redwood	Acacia	Total Loans
Fair value	$ -	$ 12,150	$ 12,150
Held-for-investment	286,070	-	286,070
Total Commercial Loans	$ 286,070	$ 12,150	$ 298,220

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2012

(Unaudited)

Note 7. Commercial Loans (continued)

December 31, 2011

(In Thousands)	Redwood	Acacia	Total Loans
Fair value	$ -	$ 12,129	$ 12,129
Held-for-investment	157,726	-	157,726
Total Commercial Loans	$ 157,726	$ 12,129	$ 169,855

Commercial Loans at Fair Value

Commercial loans at fair value are owned at the consolidated Acacia securitization entities. At both September 30, 2012 and December 31, 2011, there were three commercial loans at fair value with an aggregate outstanding principal value of $14 million and an aggregate fair value of $12 million.

Commercial Loans Held-for-Investment

Commercial loans held-for-investment include loans we originate and preferred equity investments we make or, in either case, acquire from third parties. Through September 30, 2012, these loans have typically been mezzanine loans that are secured by a borrower s ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. The preferred equity investments are typically preferred equity interests in a single purpose entity that owns commercial property and are included within, and referred to herein, as commercial loans held-for-investment due to the fact that their risks and payment characteristics are nearly equivalent to commercial mezzanine loans.

The following table provides additional information for our commercial loans held-for-investment at September 30, 2012 and December 31, 2011.

(In Thousands)	September 30, 2012	December 31, 2011
Principal balance	$ 291,595	$ 158,847
Unamortized discount, net	(3,761)	(513)
Recorded investment	287,834	158,334
Allowance for loan losses	(1,764)	(608)
Carrying Value	$ 286,070	$ 157,726

At September 30, 2012, there were 31 commercial loans held-for-investment with an outstanding principal value of $292 million and a carrying value of $286 million. Of the $288 million of recorded investment in commercial loans held-for-investment at September 30, 2012, 48% was originated in 2012, 42% was originated in 2011, 10% was originated in 2010, and less than 1% was acquired in 2004. At December 31, 2011, there were 15 commercial loans held-for-investment with an outstanding principal value of $159 million and a carrying value of $158 million. Of the $158 million of recorded investment in commercial loans held-for-investment at December 31, 2011, 81% was originated in 2011, 19% was originated in 2010, and less than 1% was acquired in 2004.

Allowance for Loan Losses on Commercial Loans

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2012

(Unaudited)

Note 7. Commercial Loans (continued)

Activity in the Allowance for Loan Losses on Commercial Loans

The following table summarizes the activity in the allowance for commercial loan losses for the three and nine months ended September 30, 2012 and 2011.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2012**	**2011**	**2012**	**2011**
Balance at beginning of period	$ 1,258	$ -	$ 608	$ -
Charge-offs, net	-	-	-	-
Provision for loan losses	506	-	1,156	-
Balance at End of Period	$ 1,764	$ -	$ 1,764	$ -

Commercial Loans Collectively Evaluated for Impairment

We record an allowance for loan losses based on our estimate of credit losses inherent in our portfolio at the reporting date. Our estimate of credit losses is informed by loss rates and delinquency trends. At September 30, 2012 and December 31, 2011, all of the commercial loans collectively evaluated for impairment were current and were assigned an impairment status of Pass. The following table summarizes the balances for loans collectively evaluated for impairment at September 30, 2012 and December 31, 2011.

(In Thousands)	**September 30, 2012**	**December 31, 2011**
Principal balance	$ 291,595	$ 158,847
Recorded investment	287,834	158,334
Related allowance	1,764	608

Commercial Loans Individually Evaluated for Impairment

We did not have any loans individually evaluated for impairment for either of the nine months ended September 30, 2012 and 2011.

Note 8. Real Estate Securities

We invest in third-party residential, commercial, and CDO securities. The following table presents the fair values of our real estate securities by collateral type and entity at September 30, 2012 and December 31, 2011.

September 30, 2012 (In Thousands)	Redwood		Acacia		Total Securities	
Residential	$	1,061,592	$	184,024	$	1,245,616
Commercial		7,619		43,443		51,062
CDO		64		15,605		15,669
Total Real Estate Securities	$	1,069,275	$	243,072	$	1,312,347

December 31, 2011 (In Thousands)	Redwood		Acacia		Total Securities	
Residential	$	744,281	$	175,062	$	919,343
Commercial		5,445		37,923		43,368
CDO		1,010		18,116		19,126
Total Real Estate Securities	$	750,736	$	231,101	$	981,837

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 8. Real Estate Securities (continued)

Senior securities are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests.

Trading Securities

We elected the fair value option for certain securities at Redwood and the Acacia entities, and classify them as trading securities. The unpaid principal balance of these trading securities was $860 million and $1.11 billion at September 30, 2012 and December 31, 2011, respectively. The following table presents trading securities by collateral type and ownership entity at September 30, 2012 and December 31, 2011.

	September 30, 2012			December 31, 2011		
(In Thousands)	**Redwood**	**Acacia**	**Total**	**Redwood**	**Acacia**	**Total**
Senior Securities						
Residential prime	$ 6,301	$ 3,095	$ 9,396	$ -	$ 3,019	$ 3,019
Residential non-prime	22,941	88,410	111,351	20,608	88,280	108,888
Commercial	-	11,592	11,592	-	11,216	11,216
Total Senior Securities	29,242	103,097	132,339	20,608	102,515	123,123
Subordinate Securities						
Residential prime	446	35,775	36,221	343	31,718	32,061
Residential non-prime	151	56,744	56,895	130	52,045	52,175
Commercial	-	31,851	31,851	-	26,707	26,707
CDO	14	15,605	15,619	960	18,116	19,076
Total Subordinate Securities	611	139,975	140,586	1,433	128,586	130,019
Total Trading Securities	$ 29,853	$ 243,072	$ 272,925	$ 22,041	$ 231,101	$ 253,142

AFS Securities

The following table presents the fair value of our available-for-sale securities held at Redwood by collateral type at September 30, 2012 and December 31, 2011.

(In Thousands)	September 30, 2012	December 31, 2011
Senior Securities		
Residential prime	$ 490,409	$ 278,240
Residential non-prime	239,871	255,724
Total Senior Securities	730,280	533,964
Re-REMIC Securities	149,973	119,366
Subordinate Securities		
Residential prime	145,096	58,717
Residential non-prime	6,404	11,153
Commercial	7,619	5,445
CDO	50	50
Total Subordinate Securities	159,169	75,365
Total AFS Securities	$ 1,039,422	$ 728,695

Of the senior securities shown above at September 30, 2012 and December 31, 2011, $177 million and $175 million, respectively, of prime securities, and $148 million and $150 million, respectively, of non-prime securities were financed through the Resecuritization entity, as discussed in *Note 4*.

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(Unaudited)

Note 8. Real Estate Securities (continued)

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

At September 30, 2012, there were $3 million of AFS residential securities that had contractual maturities greater than five years but less than ten years, and the remainder of our real estate securities had contractual maturities greater than ten years.

The following table presents the components of carrying value (which equals fair value) of AFS securities at September 30, 2012 and December 31, 2011.

Carrying Value of AFS Securities

September 30, 2012

(In Thousands)	**Residential**	**Commercial**	**CDO**	**Total**
Principal balance	$ 1,298,894	$ 40,342	$ 7,303	$ 1,346,539
Credit reserve	(199,652)	(33,206)	(7,303)	(240,161)
Unamortized discount, net	(202,029)	(3,509)	-	(205,538)
Amortized cost	897,213	3,627	-	900,840
Gross unrealized gains	140,364	4,219	50	144,633
Gross unrealized losses	(5,824)	(227)	-	(6,051)
Carrying Value	$ 1,031,753	$ 7,619	$ 50	$ 1,039,422

December 31, 2011

(In Thousands)	**Residential**	**Commercial**	**CDO**	**Total**
Principal balance	$ 1,148,952	$ 50,499	$ 10,717	$ 1,210,168
Credit reserve	(242,261)	(43,012)	(10,717)	(295,990)
Unamortized discount, net	(235,833)	(3,554)	-	(239,387)
Amortized cost	670,858	3,933	-	674,791

Gross unrealized gains	85,360	1,702	50	87,112
Gross unrealized losses	(33,018)	(190)	-	(33,208)
Carrying Value	$ 723,200	$ 5,445	$ 50	$ 728,695

The following table presents the changes for the three and nine months ended September 30, 2012, of the unamortized discount and designated credit reserves on AFS securities.

Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

Three Months Ended September 30, 2012

	Residential		**Commercial**		**CDO**	
(In Thousands)	**Credit Reserve**	**Unamortized Discount, Net**	**Credit Reserve**	**Unamortized Discount, Net**	**Credit Reserve**	**Unamortized Premium, Net**
Beginning balance - June 30, 2012	$ 221,426	$ 224,824	$ 33,013	$ 5,532	$ 7,275	$ -
Amortization of net discount	-	(7,155)	-	(190)	-	28
Realized credit losses	(11,031)	-	(2,261)	-	-	-
Acquisitions	1,184	3,598	-	-	-	-
Sales, calls, other	(8,228)	(23,523)	-	-	-	-
Impairments	586	-	621	-	-	-
Transfers to (release of) credit reserves	(4,285)	4,285	1,833	(1,833)	28	(28)
Ending Balance - September 30, 2012	$ 199,652	$ 202,029	$ 33,206	$ 3,509	$ 7,303	$ -

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2012

(Unaudited)

Note 8. Real Estate Securities (continued)

Nine Months Ended September 30, 2012

	Residential		Commercial		CDO	
(In Thousands)	**Credit Reserve**	**Unamortized Discount, Net**	**Credit Reserve**	**Unamortized Discount, Net**	**Credit Reserve**	**Unamortized Premium, Net**
Beginning balance - December 31, 2011	$ 242,261	$ 235,833	$ 43,012	$ 3,554	$ 10,717	$ -
Amortization of net discount	-	(23,553)	-	(425)	-	86
Realized credit losses	(36,939)	-	(10,158)	-	(3,500)	-
Acquisitions	12,736	47,596	-	-	-	-
Sales, calls, other	(24,384)	(52,979)	-	-	-	-
Impairments	1,110	-	732	-	-	-
Transfers to (release of) credit reserves	4,868	(4,868)	(380)	380	86	(86)
Ending Balance - September 30, 2012	$ 199,652	$ 202,029	$ 33,206	$ 3,509	$ 7,303	$ -

Credit Characteristics of AFS Securities

Of the $200 million of credit reserve on our residential securities at September 30, 2012, $40 million was related to residential senior securities, $56 million was related to residential re-REMIC securities, and $104 million was related to residential subordinate securities. The loans underlying our residential senior securities totaled $15 billion at September 30, 2012, and consisted of $10 billion prime and $5 billion non-prime credit quality at time of origination. Serious delinquencies at September 30, 2012, were 10.72% of outstanding principal balances. The loans underlying our residential re-REMIC securities totaled $7 billion at September 30, 2012, and consisted of $6.5 billion prime and $122 million non-prime credit quality collateral at time of origination. Serious delinquencies at September 30, 2012, were 10.70% of outstanding principal balances. The loans underlying our residential subordinate securities totaled $17 billion at September 30, 2012, and consisted of $16 billion prime and $1 billion non-prime credit quality at time of origination. Serious delinquencies at September 30, 2012, were 6.43% of outstanding principal balances.

The loans underlying our commercial subordinate securities totaled $5 billion at September 30, 2012, and consisted primarily of office (17%), retail (45%), and multifamily (12%) loans. Serious delinquencies (60+ days, in foreclosure or REO) at September 30, 2012 were 1.55% of current principal balances.

AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of AFS securities that were in a gross unrealized loss position at September 30, 2012 and December 31, 2011.

September 30, 2012	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
(In Thousands)	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
Residential	$ 15,943	$ (457)	$ 15,486	$ 102,041	$ (5,367)	$ 96,674
Commercial	-	-	-	1,165	(227)	938
CDO	-	-	-	-	-	-
Total Securities	$ 15,943	$ (457)	$ 15,486	$ 103,206	$ (5,594)	$ 97,612

December 31, 2011	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
(In Thousands)	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
Residential	$ 242,595	$ (21,976)	$ 220,619	$ 75,245	$ (11,042)	$ 64,203
Commercial	151	(38)	113	1,090	(152)	938
CDO	-	-	-	-	-	-
Total Securities	$ 242,746	$ (22,014)	$ 220,732	$ 76,335	$ (11,194)	$ 65,141

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

Note 8. Real Estate Securities (continued)

At September 30, 2012, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 377 AFS securities, of which 51 were in an unrealized loss position and 35 were in a continuous unrealized loss position for twelve consecutive months or longer. At December 31, 2011, our consolidated balance sheet included 425 AFS securities, of which 139 were in an unrealized loss position and 26 were in a continuous unrealized loss position for twelve consecutive months or longer.

Evaluating AFS Securities for Other-than-Temporary Impairments

When the fair value of an AFS security is below its cost basis, we evaluate the security for OTTI. Part of this evaluation is based upon adverse changes in the assumptions used to value the security. The table below summarizes the significant valuation assumptions we used for our AFS securities at September 30, 2012.

Significant Valuation Assumptions

	Range for Securities		
	Prime	Non-prime	
September 30, 2012			**Commercial**
Prepayment rates	4 - 19 %	3 - 10 %	N/A
Loss severity	26 - 59 %	29 - 60 %	33 - 50 %
Projected losses	0 - 25 %	6 - 43 %	2 - 9 %

For an AFS security where its fair value has declined below its amortized cost basis, we evaluate the security for OTTI. The credit component of OTTI is recognized through our consolidated statements of income as a component of other market valuation adjustments, net, while the non-credit component of OTTI is recognized through accumulated other comprehensive income, a component of equity. The following table details the activity related to the credit component of OTTI (i.e., OTTI in either current earnings or retained earnings) for AFS securities that also had a non-credit component and were still held at September 30, 2012 and 2011. The balance of the credit component of OTTI at September 30, 2012, includes all market valuation adjustments recorded through the income statement for securities still held on our balance sheet at September 30, 2012 and 2011 as well as a portion of OTTI previously recognized in other comprehensive income.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2012**	**2011**	**2012**	**2011**
Balance at beginning of period	$ 67,054	$ 90,019	$ 78,126	$ 121,016
Additions				
Initial credit impairments	164	519	325	982
Subsequent credit impairments	58	217	149	1,152
Reductions				
Securities sold, or expected to sell	(9,069)	-	(9,069)	(12,317)

Securities with no outstanding principal at period end	(4,310)	(11,056)	(15,634)	(31,134)
Balance at End of Period	$ 53,897	$ 79,699	$ 53,897	$ 79,699

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

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Note 8. Real Estate Securities (continued)

Gross Realized Gains and Losses on AFS Securities

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains on sales and calls of AFS securities for the three and nine months ended September 30, 2012 and 2011.

(In Thousands)	Three Months Ended September 30, 2012	2011	Nine Months Ended September 30, 2012	2011
Gross realized gains - sales	$ 13,920	$ -	$ 28,693	$ 12,665
Gross realized gains - calls	-	832	113	1,365
Gross realized losses - sales	-	-	(1,600)	(3,523)
Gross realized losses - calls	-	-	-	(223)
Total Realized Gains on Sales and Calls of AFS Securities, net	$ 13,920	$ 832	$ 27,206	$ 10,284

Note 9. Derivative Financial Instruments

The following table presents the fair value and notional amount of derivative financial instruments held by Redwood and the consolidated Acacia entities at September 30, 2012 and December 31, 2011. The derivatives held at Acacia entities are not assets or legal obligations of Redwood.

September 30, 2012	Redwood		Acacia		Total	
(In Thousands)	Fair Value	Notional Amount	Fair Value	Notional Amount	Fair Value	Notional Amount
Assets - Risk Management Derivatives						
Interest rate swaps	$ 28	$ 20,000	$ 775	$ 5,565	$ 803	$ 25,565
TBAs	-	-	-	-	-	-
Swaptions	2,487	455,000	-	-	2,487	455,000
Interest rate caps	-	-	134	370,800	134	370,800
Total Assets	$ 2,515	$ 475,000	$ 909	$ 376,365	$ 3,424	$ 851,365
Liabilities - Cash Flow Hedges						
Interest rate swaps	$ (53,450)	$ 139,500	$ -	$ -	$ (53,450)	$ 139,500
Liabilities - Risk Management Derivatives						

Interest rate swaps		(1,903)		42,500		(52,584)		512,572		(54,487)		555,072
TBAs		-		-		-		-		-		-
Futures		(618)		252,000		-		-		(618)		252,000
Total Liabilities	$	(55,971)	$	434,000	$	(52,584)	$	512,572	$	(108,555)	$	946,572

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Note 9. Derivative Financial Instruments (continued)

December 31, 2011	**Redwood**				**Acacia**				**Total**			
(In Thousands)		**Fair Value**		**Notional Amount**		**Fair Value**		**Notional Amount**		**Fair Value**		**Notional Amount**
Assets - Risk Management Derivatives												
Interest rate swaps	$	-	$	-	$	857	$	5,595	$	857	$	5,595
Futures		47		126,000		-		-		47		126,000
Interest rate caps		-		-		1,469		704,400		1,469		704,400
Total Assets	$	47	$	126,000	$	2,326	$	709,995	$	2,373	$	835,995
Liabilities - Cash Flow Hedges												
Interest rate swaps	$	(54,353)	$	165,000	$	-	$	-	$	(54,353)	$	165,000
Liabilities - Risk Management Derivatives												
Interest rate swaps		(5,270)		189,500		(62,695)		558,968		(67,965)		748,468
TBAs		(5,060)		492,000		-		-		(5,060)		492,000
Futures		(186)		180,000		-		-		(186)		180,000
Total Liabilities	$	(64,869)	$	1,026,500	$	(62,695)	$	558,968	$	(127,564)	$	1,585,468

Risk Management Derivatives

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

Certain Risks Related to Unsecuritized Residential and Commercial Loans at Redwood

In order to manage certain risks associated with residential loans we own or plan to acquire and securitize and commercial loans we invest in, at September 30, 2012, we were party to interest rate agreements with an aggregate notional amount of $517 million and financial futures contracts with an aggregate notional amount of $252 million. Net market valuation adjustments on these derivatives were negative $3 million and negative $13 million for the three months ended September 30, 2012 and 2011, respectively. Net market valuation adjustments on these derivatives were negative $10 million and negative $16 million for the nine months ended September 30, 2012 and 2011, respectively.

Certain Risks Related to Liabilities at Acacia Entities

Net valuation adjustments on interest rate agreements at Acacia were negative $4 million and negative $10 million for the three months ended September 30, 2012 and 2011, respectively. Net valuation adjustments on interest rate agreements at Acacia were negative $10 million and negative $24 million for the nine months ended September 30, 2012 and 2011, respectively.

Derivatives Designated as Cash Flow Hedges

To hedge the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated interest rate swaps as cash flow hedges during 2010 and during the second quarter of 2011 with an aggregate notional balance of $165 million. During the first half of 2012, we unwound swaps with an aggregate notional balance of $26 million that had been designated against certain adjustable-rate securitization entity liabilities. For the three and nine months ended September 30, 2012, these cash flow hedges increased in value by $2 million and decreased in value by $1 million, respectively, which was recorded as an increase and a decrease, respectively, to accumulated other comprehensive income, a component of equity. Accumulated other comprehensive loss of less than $1 million will be amortized into interest expense, a component of our consolidated income statements, over the remaining life of the hedged liabilities.

For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was $65 million at September 30, 2012, and $67 million at December 31, 2011. For both the three months ended September 30, 2012 and 2011, we reclassified $1 million of unrealized losses on derivatives to interest expense. For both the nine months ended September 30, 2012 and 2011, we reclassified $3 million of unrealized losses on derivatives to interest expense. We estimate that we will reclassify $1 million of unrealized losses to interest expense during the fourth quarter of 2012.

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Note 9. Derivative Financial Instruments (continued)

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and nine months ended September 30, 2012 and 2011.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2012**	**2011**	**2012**	**2011**
Net interest expense on cash flow interest rate agreements	$ (1,409)	$ (1,637)	$ (4,361)	$ (4,803)
Realized expense due to ineffective portion of hedges	-	(5)	(34)	(18)
Realized net losses reclassified from other comprehensive income	(1,126)	(1,067)	(3,260)	(3,211)
Total Interest Expense	$ (2,535)	$ (2,709)	$ (7,655)	$ (8,032)

Derivative Counterparty Credit Risk

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. Each of our derivative counterparties must maintain compliance with International Swaps and Derivatives Association (ISDA) agreements (or receive a waiver of non-compliance after a specific assessment) in order to conduct derivative transactions with us. Additionally, we review derivative counterparty credit standings, and in the case of a deterioration of credit worthiness, appropriate remedial action is taken. To further mitigate counterparty risk, we exit derivatives contracts with counterparties that (i) do not maintain compliance with (or obtain a waiver from) the terms of their ISDA agreements with us; or (ii) do not maintain their status as a primary government dealer or affiliate by the U.S. Department of Treasury or do not meet internally established guidelines regarding credit worthiness. Our ISDA agreements currently require full bilateral collateralization of unrealized loss exposures with our derivative counterparties. Through a margin posting process, our positions are revalued with counterparties each business day and cash margin is transferred to either us or our derivative counterparties as collateral based upon the directional changes in fair value of the positions. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments. At September 30, 2012, we assessed this risk as remote and did not record a specific valuation adjustment.

At September 30, 2012, we had outstanding derivative agreements with five bank counterparties and Acacia entities had outstanding derivative agreements with five bank counterparties. At September 30, 2012, we were in compliance with ISDA agreements governing our open derivative positions. At September 30, 2012, all Acacia entities were in compliance with ISDA agreements governing their open derivative positions, with the exception of an early termination event at September 30, 2012, with respect to one ISDA agreement at one Acacia entity due to that entity s failure to make a required swap payment. This liability is not a legal obligation of Redwood.

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Note 10. Other Assets

Other assets at September 30, 2012 and December 31, 2011, are summarized in the following table.

Other Assets

(In Thousands)	September 30, 2012	December 31, 2011
Margin receivable	$ 66,814	$ 71,976
REO	3,919	5,669
Income tax receivables	4,787	4,741
MSRs	2,655	-
Prepaid expenses	2,121	1,706
Investment receivable	538	1,741
Fixed assets and leasehold improvements	515	2,048
Other	2,660	381
Total Other Assets	$ 84,009	$ 88,262

REO consists of foreclosed properties received in full satisfaction of defaulted real estate loans. The carrying value of REO at September 30, 2012, was $4 million, which includes the net effect of $5 million related to transfers into REO during 2012, offset by $5 million of REO liquidations, a $1 million reduction related to the deconsolidation of five Sequoia securitization entities, and less than $1 million of negative market valuation adjustments. At September 30, 2012, there were 30 REO properties recorded on our consolidated balance sheet, all of which were owned at consolidated Sequoia entities. At December 31, 2011, there were 43 REO properties recorded on our consolidated balance sheet, all of which were owned at consolidated Sequoia entities. Properties located in Ohio, Michigan, Georgia, Colorado, and Florida accounted for 77% of our REO properties at September 30, 2012.

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

See *Note 17* for additional information on MSRs.

Note 11. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At September 30, 2012, we had outstanding agreements with 10 bank counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q. The table below summarizes the facilities that are available to us and the balances of short-term debt at September 30, 2012 and December 31, 2011, by the type of collateral securing the debt.

(Dollars in Thousands)	Number of Facilities	September 30, 2012 Outstanding	Limit	Maturity
Collateral Type				
Residential loans	3	$ 156,866	$ 600,000	11/2012 - 7/2013
Real estate securities	7	365,348	-	10/2012 - 2/2013
Total	10	$ 522,214		

(Dollars in Thousands)	Number of Facilities	December 31, 2011 Outstanding	Limit	Maturity
Collateral Type				
Residential loans	2	$ 307,149	$ 400,000	11/2012
Real estate securities	4	120,907	-	1/2012 - 2/2012
Total	6	$ 428,056		

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Note 11. Short-Term Debt (continued)

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At September 30, 2012, the fair value of residential loans and securities pledged as collateral were $180 million and $471 million, respectively. They are uncommitted and mature within a year. For the three and nine months ended September 30, 2012, the average balance of short-term debt was $571 million and $469 million, respectively. For the three and nine months ended September 30, 2011, the average balance of short-term debt was $18 million and $23 million, respectively. At September 30, 2012 and December 31, 2011, accrued interest payable on short-term debt was $1 million and less than $1 million, respectively.

Characteristics of Short-Term Debt

The table below summarizes short-term debt by weighted average interest rates and by collateral type at September 30, 2012 and December 31, 2011.

	September 30, 2012			December 31, 2011		
(In Thousands)	**Amount Borrowed**	**Weighted Average Interest**	**Weighted Average Days Until**	**Amount Borrowed**	**Weighted Average Interest**	**Weighted Average Days Until**
Collateral Type						
Residential loan	$ 156,866	1.75%	225	$ 307,149	1.93%	322
Real estate securities	365,348	1.89%	36	120,907	1.88%	31
Total Short-Term Debt	$ 522,214	1.85%	93	$ 428,056	1.92%	240

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of short-term debt at September 30, 2012 and December 31, 2011.

(In Thousands)	**September 30, 2012**	**December 31, 2011**
Within 30 days	$ 301,369	$ 105,607
31 to 90 days	97,127	15,300
Over 90 days	123,718	307,149
Total Short-Term Debt	$ 522,214	$ 428,056

Note 12. Asset-Backed Securities Issued

The Sequoia and Acacia securitization entities issue ABS to acquire assets from us and from third parties. Each series of ABS issued consists of various classes that pay interest on a monthly or quarterly basis. Substantially all ABS issued pay variable rates of interest, which are indexed to one, three, or six-month LIBOR. Some ABS issued pay fixed rates of interest or pay hybrid rates, which are fixed rates that subsequently adjust to variable rates. ABS issued also includes some interest-only classes with coupons set at a fixed rate or a fixed spread to a benchmark rate, or set at a spread to the interest rates earned on the assets less the interest rates paid on the liabilities of a securitization entity.

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(Unaudited)

Note 12. Asset-Backed Securities Issued (continued)

In 2011, we securitized and consolidated $671 million of loans through our Sequoia program and issued $640 million of ABS to third parties. In July 2011, we transferred $365 million of residential securities into a resecuritization, with $245 million of ABS issued to third parties. The carrying value of ABS issued by consolidated securitization entities we sponsored at September 30, 2012 and December 31, 2011, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

	September 30, 2012			
(Dollars in Thousands)	**Sequoia**	**Acacia**	**Resecuritization**	**Total**
Certificates with principal balance	$ 2,986,293	$ 2,379,256	$ 178,960	$ 5,544,509
Interest-only certificates	13,466	-	-	13,466
Unamortized premium	1,000	-	-	1,000
Unamortized discount	(6,123)	-	-	(6,123)
Fair value adjustment, net	-	(2,123,845)	-	(2,123,845)
Total ABS Issued	$ 2,994,636	$ 255,411	$ 178,960	$ 3,429,007
Range of weighted average interest rates, by series	0.34% to 4.16%	0.93% to 1.44%	2.23%	
Stated maturities	2014 - 2047	2039 - 2047	2046	
Number of series	34	9	1	

	December 31, 2011			
(Dollars in Thousands)	**Sequoia**	**Acacia**	**Resecuritization**	**Total**
Certificates with principal balance	$ 3,697,894	$ 2,884,967	$ 219,551	$ 6,802,412
Interest-only certificates	16,904	-	-	16,904
Unamortized premium	1,280	-	-	1,280
Unamortized discount	(5,655)	-	-	(5,655)
Fair value adjustment, net	-	(2,675,586)	-	(2,675,586)
Total ABS Issued	$ 3,710,423	$ 209,381	$ 219,551	$ 4,139,355
Range of weighted average interest rates, by series	0.39% to 4.15%	0.76% to 1.94%	2.19%	
Stated maturities	2014 - 2047	2039 - 2052	2046	
Number of series	39	10	1	

The maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its stated maturity. At September 30, 2012, $3.38 billion of ABS issued ($5.50 billion principal balance) had contractual maturities of over five years and $47 million of ABS issued ($47 million principal balance) had contractual maturities of one to five years. Amortization of the Resecuritization and Sequoia deferred ABS issuance costs was $1 million for both the nine months ended September 30, 2012 and 2011.

The following table summarizes the accrued interest payable on ABS issued at September 30, 2012 and December 31, 2011. Interest due on Sequoia and Resecuritization ABS issued is payable monthly and interest due on Acacia ABS issued is payable quarterly.

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	**September 30, 2012**	**December 31, 2011**
Sequoia	$ 3,051	$ 3,978
Acacia	1,713	2,894
Resecuritization	44	42
Total Accrued Interest Payable on ABS Issued	$ 4,808	$ 6,914

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Note 12. Asset-Backed Securities Issued (continued)

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at September 30, 2012 and December 31, 2011.

Collateral for Asset-Backed Securities Issued

	September 30, 2012			
(In Thousands)	**Sequoia**	**Acacia**	**Resecuritization**	**Total**
Real estate loans	$ 3,076,580	$ 12,150	$ -	$ 3,088,730
Real estate securities	-	243,072	325,226	568,298
REO	3,919	-	-	3,919
Restricted cash	342	42,104	-	42,446
Accrued interest receivable	6,502	1,733	883	9,118
Total Collateral for ABS Issued	$ 3,087,343	$ 299,059	$ 326,109	$ 3,712,511

	December 31, 2011			
(In Thousands)	**Sequoia**	**Acacia**	**Resecuritization**	**Total**
Real estate loans	$ 3,799,648	$ 12,129	$ -	$ 3,811,777
Real estate securities	-	246,212	324,705	570,917
REO	5,669	-	-	5,669
Restricted cash	287	14,600	-	14,887
Accrued interest receivable	7,786	2,065	961	10,812
Total Collateral for ABS Issued	$ 3,813,390	$ 275,006	$ 325,666	$ 4,414,062

Note 13. Long-Term Debt

In 2006, we issued $100 million of trust preferred securities through Redwood Capital Trust I, a Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating coupon rate equal to three-month LIBOR plus 2.25% until the notes are redeemed, which will be no later than January 30, 2037. The interest expense yield on our trust preferred securities was 2.83% and 2.62% for the nine months ended September 30, 2012 and 2011, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our trust preferred securities was 6.87% and 6.88% for the nine months ended September 30, 2012 and 2011, respectively. The earliest optional redemption date without penalty was January 30, 2012. In December 2010, we repurchased $500 thousand principal amount of these trust preferred securities.

In 2007, we issued an additional $50 million of subordinated notes. These subordinated notes require quarterly distributions at a floating interest rate equal to six-month LIBOR plus 2.25% until the notes are redeemed, which will be no later than July 30, 2037. The interest expense yield on our subordinated notes was 2.83% and 2.62% for the nine months ended September 30, 2012 and 2011, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our subordinated notes was 6.87% and 6.88% for the nine months ended September 30, 2012 and 2011, respectively. The earliest optional redemption date without a penalty was July 30, 2012. In July 2009, we repurchased $10 million principal amount of this subordinated debt.

At both September 30, 2012 and December 31, 2011, the accrued interest payable balance on long-term debt was less than $1 million. Under the terms of our long-term debt, we covenant to, among other things, our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of our long-term debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is *pari passu* or subordinate to our long-term debt.

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Note 14. Commitments and Contingencies

Lease Commitments

At September 30, 2012, we were obligated under non-cancelable operating leases with expiration dates through 2018 for $10 million. Operating lease expense was less than $1 million for both the nine months ended September 30, 2012 and 2011.

The following table presents our future lease commitments at September 30, 2012.

Future Lease Commitments by Year

(In Thousands)		September 30, 2012
2012 (three months)	$	434
2013		1,779
2014		1,820
2015		1,776
2016		1,518
2017 and thereafter		2,213
Total	$	9,540

Leasehold improvements for our offices are amortized into expense over the prior lease term, expiring in 2012. There were no unamortized leasehold improvements at September 30, 2012. For both the nine months ended September 30, 2012 and 2011, we recognized leasehold amortization expense of $1 million.

Loss Contingencies Litigation

On December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants). The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of a mortgage pass-through certificate (or, residential mortgage backed securities, RMBS) issued through our Sequoia RMBS platform (as part of the Sequoia Mortgage Trust 2005-4 securitization transaction) and purchased by the FHLB-Seattle. The FHLB-Seattle also seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys fees and costs. On June 10, 2010, the FHLB-Seattle filed an amended complaint. Subsequently, on October 18, 2010, the FHLB-Seattle Defendants filed motions to dismiss the FHLB-Seattle s complaint. Redwood Trust, Inc. and SRF additionally moved to dismiss the complaint for lack of personal jurisdiction. The FHLB-Seattle alleges that the FHLB-Seattle Defendants offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the loans securitized in this transaction. Among other things, the FHLB-Seattle alleges that the FHLB-Seattle Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these mort