REDWOOD TRUST INC
Form 10-Q
August 07, 2015
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UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: June 30, 2015

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 o
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 o Non-accelerated filer o Smaller reporting company o

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

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

Common Stock, $0.01 par value per share	84,567,744 shares outstanding as of August 7, 2015

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data) (Unaudited)	June 30, 2015	December 31, 2014
ASSETS [1]		
Residential loans, held-for-sale, at fair value	$892,081	$1,342,519
Residential loans, held-for-investment, at fair value [2]	2,394,399	2,056,054
Commercial loans, held-for-sale, at fair value	165,853	166,234
Commercial loans, held-for-investment (includes $69,763 and $71,262 at fair value)	385,478	400,693
Real estate securities, at fair value	1,157,599	1,379,230
Mortgage servicing rights, at fair value	168,462	139,293
Cash and cash equivalents	226,426	269,730
Total earning assets	5,390,298	5,753,753
Restricted cash	2,389	628
Accrued interest receivable	16,151	18,222
Derivative assets	26,252	16,417
Deferred securities issuance costs	13,174	16,050
Other assets	147,620	113,896
Total Assets	$5,595,884	$5,918,966
LIABILITIES AND EQUITY [1]		
Liabilities		
Short-term debt	$1,367,062	$1,793,825
Accrued interest payable	8,291	8,503
Derivative liabilities	54,109	58,331
Accrued expenses and other liabilities	49,925	52,244
Deferred tax liability	10,237	10,236
Asset-backed securities issued (includes $1,173,336 and $0 at fair value) [2]	1,262,122	1,545,119
Long-term debt (includes $65,232 and $66,707 at fair value)	1,579,354	1,194,567
Total liabilities	4,331,100	4,662,825
Equity		
Common stock, par value $0.01 per share, 180,000,000 shares authorized; 84,552,232 and 83,443,141 issued and outstanding	846	834
Additional paid-in capital	1,779,330	1,774,030
Accumulated other comprehensive income	140,694	140,688
Cumulative earnings	958,460	906,867
Cumulative distributions to stockholders	(1,614,546)	(1,566,278)
Total equity	1,264,784	1,256,141
Total Liabilities and Equity	$5,595,884	$5,918,966

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(1) Our consolidated balance sheets include assets of consolidated variable interest entities ("VIEs") that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At June 30, 2015 and December 31, 2014, assets of consolidated VIEs totaled $1,622,636 and $1,900,208, respectively, and liabilities of consolidated VIEs totaled $1,263,249 and $1,546,490, respectively. See Note 4 for further discussion.

(2)

On January 1, 2015, we adopted ASU 2014-13 and began to account for residential loans held-for-investment and asset backed securities issued at consolidated Sequoia entities (which are VIEs) at fair value. At December 31, 2014, amounts presented in residential loans held-for-investment for these assets included $1,474,386 at historical cost. See Note 3 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 June 30,		Six Months Ended June 30,	
(Unaudited)	2015	2014	2015	2014
Interest Income				
Residential loans	$25,808	$13,601	$50,817	$26,259
Commercial loans	12,679	11,217	23,593	21,601
Real estate securities	24,839	33,170	52,614	65,601
Other interest income	47	5	95	8
Total interest income	63,373	57,993	127,119	113,469
Interest Expense				
Short-term debt	(6,527)	(5,142)	(13,751)	(8,969)
Asset-backed securities issued	(5,645)	(8,183)	(11,847)	(16,624)
Long-term debt	(10,836)	(7,826)	(21,371)	(14,618)
Total interest expense	(23,008)	(21,151)	(46,969)	(40,211)
Net Interest Income	40,365	36,842	80,150	73,258
Reversal of (provision for) loan losses	261	315	55	(967)
Net Interest Income After Provision	40,626	37,157	80,205	72,291
Non-interest Income				
Mortgage banking and investment activities, net (1)	5,659	2,189	6,437	(4,181)
Mortgage servicing rights income (loss), net	830	(1,777)	(10,094)	(1,171)
Other income	1,299	—	2,108	—
Realized gains, net	6,316	1,063	10,622	2,155
Total non-interest income (loss)	14,104	1,475	9,073	(3,197)
Operating expenses	(25,218)	(22,282)	(50,281)	(42,254)
Net income before provision for income taxes	29,512	16,350	38,997	26,840
(Provision for) benefit from income taxes	(2,448)	(333)	2,868	1,510
Net Income	$27,064	$16,017	$41,865	$28,350
Basic earnings per common share	$0.31	$0.19	$0.48	$0.33
Diluted earnings per common share	$0.31	$0.18	$0.47	$0.32
Regular dividends declared per common share	$0.28	$0.28	$0.56	$0.56
Basic weighted average shares outstanding	83,936,844	82,740,012	83,650,170	82,575,636
Diluted weighted average shares outstanding	94,949,741	85,032,998	85,473,905	84,994,321

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(1) For the three months ended June 30, 2015, there were no other-than-temporary impairments. For the three months ended June 30, 2014, other-than-temporary impairments were $2,915, of which $264 were recognized through the Income Statement and $2,651 were recognized in Accumulated Other Comprehensive Income.

For the six months ended June 30, 2015, there were no other-then-temporary impairments. For the six months ended June 30, 2014, other-than-temporary impairments were $4,585, of which $377 were recognized through the Income Statement, and $4,208 were recognized in Accumulated Other Comprehensive Income.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
(Unaudited)	2015	2014	2015	2014
Net Income	$27,064	$16,017	$41,865	$28,350
Other comprehensive income:				
Net unrealized (loss) gain on available-for-sale securities	(5,080)	12,721	(28)	33,229
Reclassification of unrealized (gain) loss on available-for-sale securities to net income	(5,360)	(454)	(7,050)	(341)
Net unrealized gain (loss) on interest rate agreements	15,468	(5,401)	7,026	(14,196)
Reclassification of unrealized loss on interest rate agreements to net income	26	39	58	99
Total other comprehensive income	5,054	6,905	6	18,791
Total Comprehensive Income	$32,118	$22,922	$41,871	$47,141

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 Six Months Ended June 30, 2015

(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	Total
December 31, 2014	83,443,141	$834	$1,774,030	$140,688	$906,867	$(1,566,278)	$1,256,141
Cumulative effect adjustment - adoption of ASU 2014-13 [(1)]	—	—	—	—	9,728	—	9,728
January 1, 2015	83,443,141	834	1,774,030	140,688	916,595	(1,566,278)	1,265,869
Net income	—	—	—	—	41,865	—	41,865
Other comprehensive income	—	—	—	6	—	—	6
Issuance of common stock:							
Dividend reinvestment & stock purchase plans	418,508	4	6,830	—	—	—	6,834
Employee stock purchase and incentive plans	690,683	8	(7,723)	—	—	—	(7,715)
Non-cash equity award compensation	—	—	6,193	—	—	—	6,193
Common dividends declared	—	—	—	—	—	(48,268)	(48,268)
June 30, 2015	84,552,332	$846	$1,779,330	$140,694	$958,460	$(1,614,546)	$1,264,784

For the Six Months Ended June 30, 2014

(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	Total
December 31, 2013	82,504,801	$825	$1,760,899	$148,766	$806,298	$(1,471,005)	$1,245,783
Net income	—	—	—	—	28,350	—	28,350
Other comprehensive income	—	—	—	18,791	—	—	18,791
Issuance of common stock:							
Dividend reinvestment &	179,187	2	3,473	—	—	—	3,475

stock purchase plans							
Employee stock purchase and incentive plans	396,130	4	(6,667)	—	—	—	(6,663)
Non-cash equity award compensation	—	—	6,681	—	—	—	6,681
Common dividends declared	—	—	—	—	—	(47,513)	(47,513)
June 30, 2014	83,080,118	$831	$1,764,386	$167,557	$834,648	$(1,518,518)	$1,248,904

(1) On January 1, 2015, we adopted ASU 2014-13. See Note 3 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 CASH FLOWS

(In Thousands)	Six Months Ended June 30,	
(Unaudited)	2015	2014
Cash Flows From Operating Activities:		
Net income	$41,865	$28,350
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(18,310)	(17,521)
Depreciation and amortization of non-financial assets	315	232
Purchases of held-for-sale loans	(5,656,836)	(3,118,457)
Proceeds from sales of held-for-sale loans	5,366,705	2,339,023
Principal payments on held-for-sale loans	29,282	12,100
Net settlements of derivatives	(36,622)	(14,873)
Provision for loan losses	(55)	967
Non-cash equity award compensation expense	6,193	6,681
Market valuation adjustments	21,478	13,329
Realized gains, net	(10,622)	(2,155)
Net change in:		
Accrued interest receivable and other assets	(28,265)	(23,935)
Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities	(1,390)	(9,950)
Net cash used in operating activities	(286,262)	(786,209)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(9,350)	(38,991)
Principal payments on loans held-for-investment	243,179	146,656
Purchases of real estate securities	(57,178)	(126,162)
Proceeds from sales of real estate securities	271,963	1,313
Principal payments on real estate securities	62,090	95,303
Purchase of mortgage servicing rights	(15,993)	(3,054)
Proceeds from sales of mortgage servicing rights	17,235	—
Net change in restricted cash	(1,761)	5
Net cash provided by investing activities	510,185	75,070
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	3,605,887	2,417,438
Repayments on short-term debt	(4,032,650)	(1,561,771)
Repayments on asset-backed securities issued	(174,949)	(174,861)
Deferred securities issuance costs	(33)	—
Proceeds from issuance of long-term debt	637,396	69,181
Repayments on long-term debt	(251,134)	(685)
Net settlements of derivatives	999	(1,650)
Net proceeds from issuance of common stock	3,498	1,787
Taxes paid on equity award distributions	(7,973)	(6,909)
Dividends paid	(48,268)	(47,513)
Net cash (used in) provided by financing activities	(267,227)	695,017
Net increase (decrease) in cash and cash equivalents	(43,304)	(16,122)
Cash and cash equivalents at beginning of period	269,730	173,201
Cash and cash equivalents at end of period	$226,426	$157,079
Supplemental Cash Flow Information:		
Cash paid during the period for:		

Interest	$41,440	$38,158
Taxes	48	1,399
Supplemental Noncash Information:		
Real estate securities retained from loan securitizations	$39,698	$85,000
Retention of mortgage servicing rights from loan securitizations and sales	36,834	11,976
Transfers from loans held-for-sale to loans held-for-investment	663,666	37,631
Transfers from residential loans to real estate owned	4,780	1,832

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2015
(Unaudited)

Note 1. Organization

Redwood Trust, Inc., together with its subsidiaries, focuses on investing in mortgage- and other real estate-related assets and engaging in residential and commercial mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential and commercial mortgage banking activities. We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. References herein to “Redwood,” the “company,” “we,” “us,” and “our” include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires.

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), beginning with its taxable year ended December 31, 1994. 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 generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as “the REIT” or “our REIT.” We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as “our operating subsidiaries” or “our taxable REIT subsidiaries” or “TRS.” We generally intend to distribute as dividends at least 90% of the taxable income we generate at our REIT.

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2015 and December 31, 2014, and for the three and six months ended June 30, 2015 and 2014. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with consolidated financial statements and notes thereto included in the company's Annual Report on Form 10-K for the year ended December 31, 2014. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at June 30, 2015 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2015 should not be construed as indicative of the results to be expected for the full year.

In the second quarter of 2015, we began to specifically identify derivatives that are used to hedge our exposure to market interest rate risk associated with our MSR investments. As a result, beginning in the second quarter of 2015, we have changed our income statement presentation to include the change in market value of these derivatives in the line item “Mortgage servicing rights income (loss), net.” As we previously managed our market interest rate risk on a portfolio-wide basis and did not necessarily rely on derivatives to hedge our MSRs, we cannot conform prior periods to the current presentation. Therefore, in periods prior to the second quarter of 2015 presented in our consolidated statements of income, amounts in “Mortgage servicing rights income (loss), net” do not reflect the impact of hedging.

These changes and year-over-year comparisons are discussed in further detail in Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations in this quarterly report on Form 10-Q. Additionally, beginning in the second quarter of 2015, we have combined our "Mortgage banking activities" and "Other market valuation adjustments" line items on our consolidated statements of income into a single line, now called "Mortgage banking and investment activities, net." As we currently manage our market interest rate risk on the remainder of our assets (excluding MSRs) on a net basis, we believe that combining these two line items will better reflect the net effect of our hedging activities on the assets associated with derivatives that are marked-to-market each quarter. We have conformed the presentation of prior periods related to this change for consistency of comparison.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2015
(Unaudited)
Note 2. Basis of Presentation - (continued)

Principles of Consolidation

In accordance with GAAP, we 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 certain Sequoia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during 2011 ("Residential Resecuritization"), and an entity formed in connection with a commercial securitization we engaged in during 2012 ("Commercial Securitization"). Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

For financial reporting purposes, the underlying loans and securities owned at the consolidated Sequoia entities, the Residential Resecuritization entity, and the Commercial Securitization entity are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The asset-backed securities ("ABS") issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned at these entities and interest expense on the ABS issued by these entities as well as other income and expenses associated with these entities' activities.

See Note 4 for further discussion on principles of consolidation.

Use of Estimates

The preparation of financial statements requires us to make a number of significant estimates. These include estimates of fair value of certain assets and liabilities, amounts and timing of credit losses, prepayment rates, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported periods. 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.

Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies

Included in Note 3 to the Consolidated Financial Statements of our 2014 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company's consolidated financial condition and results of operations for the three and six months ended June 30, 2015.

Recent Accounting Pronouncements

Adoption of ASU 2014-13

In November 2014, the FASB issued ASU 2014-13, "Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity" (ASU 2014-13). This update provides a measurement alternative to companies that consolidate collateralized financing entities ("CFEs"). Under the new guidance, companies can measure both the financial assets and financial liabilities of a CFE using the more observable of the fair value of the financial assets or fair value of the financial liabilities. This guidance is effective in the first quarter 2016 with early adoption permitted at the beginning of an annual period. The guidance can be applied either retrospectively to all relevant prior periods or by a modified retrospective approach with a cumulative-effect adjustment to equity as of the beginning of the annual period of adoption.

On January 1, 2015, we elected to early adopt ASU 2014-13, as we determined this measurement alternative more accurately reflects our economic interests in, and financial results from, certain consolidated financing entities. We adopted the measurement alternative under this standard only for our consolidated Sequoia entities, which qualify under the standard as CFEs. We did not elect the measurement alternative for our Residential Resecuritization or our Commercial Resecuritization, and will continue to account for the assets and liabilities in these CFEs in accordance with existing accounting guidance.

Under the provisions of ASU 2014-13, we use the fair value of the liabilities issued by the Sequoia CFEs (which we determined to be more observable) to determine the fair value of the assets, whereby the net assets we consolidate in our financial statements related

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

to these entities represents the estimated fair value of our retained interests in the Sequoia CFEs. Similarly, the periodic net market valuation adjustments we record on our income statement from the consolidated assets and liabilities of the CFEs represents the change in fair value of our retained interests in the Sequoia CFEs.

Using the modified retrospective approach, we recorded a cumulative-effect adjustment to equity of $10 million through retained earnings as of January 1, 2015. This cumulative-effect adjustment represents the net effect of adjusting the assets and liabilities of the Sequoia CFEs from amortized historical cost to fair value.

Subsequent to the adoption of ASU 2014-13, the consolidated assets and liabilities of the Sequoia CFEs are both carried at fair value, with the periodic net changes in fair value recorded on our income statement, in mortgage banking and investment activities, net.

The following table presents the assets and liabilities of the consolidated Sequoia entities at December 31, 2014 prior to the adoption of ASU 2014-13, the adjustments required to adopt the new standard, and the adjusted balances at January 1, 2015.

Impact of Adoption of ASU 2014-13 on Balance Sheet [(1)]

(In Millions)	December 31, 2014	ASU 2014-13 Adjustment	January 1, 2015
Loan Principal	$1,486	$—	$1,486
Loan unamortized premium	13	(13)	—
Allowance for loan losses	(21)	21	—
Loan market valuation adjustment	—	(113)	(113)
Residential loans held-for-investment	1,478	(105)	1,373
Deferred bond issuance costs	1	(1)	—
Other assets	5	—	5
Total assets	1,482	(105)	1,377
ABS issued principal	1,428	—	1,428
ABS issued unamortized discount	(10)	10	—
ABS market valuation adjustment	—	(125)	(125)
Total liabilities	1,418	(115)	1,303
Redwood's investment in consolidated Sequoia entities	$64	$10	$74

(1) Certain totals may not foot due to rounding.

Other Recent Accounting Pronouncements

In April 2015, the FASB issued ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs." This new guidance requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount. This new guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The new guidance is required to be applied on a retrospective basis. We plan to adopt this new guidance by the required date and will reclassify our deferred securities issuance costs costs that we currently present on the face of our consolidated balance sheets and present them as debt discounts.

In February 2015, the FASB issued ASU 2015-02, "Consolidation (Topic 810) - Amendments to the Consolidation Analysis." This new guidance provides a new scope exception for certain money market funds, makes targeted amendments to the current consolidation guidance, and ends the deferral granted to investment companies from applying the VIE guidance. This new guidance is effective for annual periods beginning after December 15, 2015. Early adoption is allowed, including in any interim period. We are evaluating the impact of adopting this new standard.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2015
(Unaudited)

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

In June 2014, the FASB issued ASU 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures." This new guidance amends the accounting guidance for "repo-to-maturity" transactions and repurchase agreements executed as repurchase financings. In addition, the new standard requires a transferor to disclose more information about certain transactions, including those in which it retains substantially all of the exposure to the economic returns of the underlying transferred asset over the transaction's term. This new guidance is effective in the first interim reporting period beginning after December 15, 2014. However, for repurchase and securities lending transactions reported as secured borrowings, the new standard's enhanced disclosures are effective for annual periods beginning after December 15, 2014 and interim periods beginning after March 15, 2015. We adopted the new guidance, as required, in the first quarter of 2015 and adopted the disclosure requirements in the second quarter of 2015, as required, which are included in Note 12 of these notes to our consolidated financial statements. The adoption in the first quarter of 2015 did not have a material impact on our financial statements, as we did not have repo-to-maturity transactions outstanding.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers." The update modifies the guidance companies use to recognize revenue from contracts with customers for transfers of goods or services and transfers of nonfinancial assets, unless those contracts are within the scope of other standards. The guidance also requires new qualitative and quantitative disclosures, including information about contract balances and performance obligations. In July 2015, the FASB approved a one year deferral of the effective date. Accordingly, the Update is effective for us in the first quarter of 2018 with retrospective application to prior periods presented or as a cumulative effect adjustment in the period of adoption. Early adoption is permitted in the first quarter of 2017. We are evaluating the impact the update will have on our consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure." This update to the receivable guidance clarifies when a creditor is considered to have received physical possession of residential real estate resulting from an in substance repossession or foreclosure. In addition, the amendments require disclosure of both: (i) the amount of foreclosed residential real estate property held by the creditor; and (ii) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The update requires the guidance to be applied using either a modified retrospective transition method or a prospective transition method for interim and annual periods beginning after December 15, 2014, with early adoption permitted. We adopted this standard in the first quarter of 2015, as required, and it did not have a material impact on our financial statements.

Balance Sheet Netting

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

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

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at June 30, 2015 and December 31, 2014.

Offsetting of Financial Assets, Liabilities, and Collateral

June 30, 2015 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet [1]		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
Assets [2]						
Interest rate agreements	$9,017	$—	$9,017	$(3,555)	$(4,822)	$640
Credit default index swaps	3,792	—	3,792	—	—	3,792
TBAs	7,627	—	7,627	(4,739)	(1,563)	1,325
Total Assets	$20,436	$—	$20,436	$(8,294)	$(6,385)	$5,757
Liabilities [2]						
Interest rate agreements	$(43,982)	$—	$(43,982)	$3,555	$40,018	$(409)
TBAs	(5,466)	—	(5,466)	4,739	340	(387)
Futures	(260)	—	(260)	—	260	—
Loan warehouse debt	(873,673)	—	(873,673)	873,673	—	—
Security repurchase agreements	(493,389)	—	(493,389)	493,389	—	—
Total Liabilities	$(1,416,770)	$—	$(1,416,770)	$1,375,356	$40,618	$(796)

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

December 31, 2014 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet [1] Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets [2]						
Interest rate agreements	$7,006	$—	$7,006	$(1,160)	$(4,360)	$1,486
Credit default index swaps	1,598	—	1,598	—	(375)	1,223
TBAs	6,653	—	6,653	(5,815)	—	838
Total Assets	$15,257	$—	$15,257	$(6,975)	$(4,735)	$3,547
Liabilities [2]						
Interest rate agreements	$(48,173)	$—	$(48,173)	$1,160	47,013	$—
TBAs	(9,506)	—	(9,506)	5,815	2,715	(976)
Futures	(372)	—	(372)	—	372	—
Loan warehouse debt	(1,185,316)	—	(1,185,316)	1,185,316	—	—
Security repurchase agreements	(608,509)	—	(608,509)	608,509	—	—
Total Liabilities	$(1,851,876)	$—	$(1,851,876)	$1,800,800	$50,100	$(976)

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

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

For each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions within that category between us and a counterparty are subject to a master netting arrangement or similar agreement with that counterparty that provides for individual transactions to be aggregated and treated as a single transaction. For certain categories of these instruments, some of our transactions are cleared and settled through one or more clearinghouses that are substituted as our counterparty. References herein to master netting arrangements or similar agreements include the arrangements and agreements governing the clearing and settlement of these transactions through the clearinghouses. In the event of the termination and close-out of any of those transactions, the corresponding master netting agreement or similar agreement provides for settlement on a net basis. Any such settlement would include the proceeds of the liquidation of any corresponding collateral, subject to certain limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party. Such limitations should not inhibit the eventual practical realization of the principal benefits of those transactions or the corresponding master netting arrangement or similar agreement and any corresponding collateral.

Note 4. Principles of Consolidation

GAAP requires us to consider whether securitizations we sponsor and other transfers of financial assets should be treated as sales or financings, as well as whether any VIEs that we hold variable interests in – 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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Note 4. Principles of Consolidation - (continued)

Analysis of Consolidated VIEs
As of June 30, 2015, the VIEs we are required to consolidate include certain Sequoia securitization entities, the Residential Resecuritization entity, and the Commercial Securitization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. 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

June 30, 2015 (Dollars in Thousands)	Sequoia Entities	Residential Resecuritization	Commercial Securitization	Total
Residential loans, held-for-investment	$1,237,114	$—	$—	$1,237,114
Commercial loans, held-for-investment	—	—	182,184	182,184
Real estate securities	—	195,278	—	195,278
Restricted cash	147	—	139	286
Accrued interest receivable	1,589	409	1,367	3,365
Other assets	4,409	—	—	4,409
Total Assets	$1,243,259	$195,687	$183,690	$1,622,636
Accrued interest payable	$797	$2	$328	$1,127
Asset-backed securities issued	1,173,336	18,872	69,914	1,262,122
Total Liabilities	$1,174,133	$18,874	$70,242	$1,263,249
Number of VIEs	24	1	1	26

Since 2012, we have transferred residential loans to 25 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 and continue to hold the servicing rights, we recorded MSRs on our consolidated balance sheets, 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. Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSRs (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.
The following table presents information related to securitization transactions that occurred during the three and six months ended June 30, 2015 and 2014.
Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Principal balance of loans transferred	$699,655	$347,305	$1,038,451	$347,305
Trading securities retained, at fair value	29,966	69,563	33,389	69,563
AFS securities retained, at fair value	3,450	20,428	6,309	20,428
MSRs recognized	6,002	2,186	7,874	2,186

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Note 4. Principles of Consolidation - (continued)

The following table summarizes the cash flows during the three and six months ended June 30, 2015 and 2014 between us and the unconsolidated VIEs sponsored by us.

Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Proceeds from new transfers	$676,596	$267,776	$1,018,312	$267,776
MSR fees received	3,700	3,624	7,470	7,047
Funding of compensating interest	(107)	(43)	(197)	(76)
Cash flows received on retained securities	10,706	15,924	23,351	28,227

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

Assumptions Related to Assets Retained from Unconsolidated VIEs Sponsored by Redwood

	Issued During The Three Months Ended June 30, 2015			Six Months Ended June 30, 2015		
At Date of Securitization	MSRs	Senior Securities	Subordinate Securities	MSRs	Senior Securities	Subordinate Securities
Prepayment rate	5 - 13%	8%	8%	5-15%	8%	8%
Discount rates	11%	3%	6%	11%	3%	6%
Credit loss assumptions	N/A	0.25%	0.25%	N/A	0.25%	0.25%

	Issued During The Three Months Ended June 30, 2014			Six Months Ended June 30, 2014		
At Date of Securitization	MSRs	Senior Securities	Subordinate Securities	MSRs	Senior Securities	Subordinate Securities
Prepayment rate	5 - 15%	10%	10%	5 - 15%	10%	10%
Discount rates	11%	3%	5%	11%	3%	5%
Credit loss assumptions	N/A	0.25%	0.25%	N/A	0.25%	0.25%

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Note 4. Principles of Consolidation - (continued)

The following table presents additional information at June 30, 2015 and December 31, 2014, related to unconsolidated securitizations accounted for as sales since 2012.

Unconsolidated VIEs Sponsored by Redwood		
(In Thousands)	June 30, 2015	December 31, 2014
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	$72,505	$93,802
Senior and subordinate securities, classified as AFS	294,040	460,990
Mortgage servicing rights	65,753	56,801
Maximum loss exposure (1)	432,298	611,593
Assets transferred:		
Principal balance of loans outstanding	7,570,297	7,276,825
Principal balance of delinquent loans 30+ days delinquent	17,646	17,022

(1) Maximum loss exposure from our involvement with unconsolidated VIEs pertains to the carrying value of our securities and MSRs 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.

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Note 4. Principles of Consolidation - (continued)

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at June 30, 2015 and December 31, 2014.

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

June 30, 2015 (Dollars in Thousands)	MSRs		Senior Securities [1]		Subordinate Securities	
Fair value at June 30, 2015	$65,753		$62,427		$304,118	
Expected life (in years) [2]	8		7		12	
Prepayment speed assumption (annual CPR) [2]	10	%	10	%	11	%
Decrease in fair value from:						
10% adverse change	$2,780		$1,920		$825	
25% adverse change	6,242		4,543		2,114	
Discount rate assumption [2]	11	%	9	%	6	%
Decrease in fair value from:						
100 basis point increase	$3,004		$2,689		$24,530	
200 basis point increase	5,514		5,166		45,844	
Credit loss assumption [2]	N/A		0.25	%	0.25	%
Decrease in fair value from:						
10% higher losses	N/A		$241		$19,746	
25% higher losses	N/A		316		24,061	

December 31, 2014 (Dollars in Thousands)	MSRs		Senior Securities [1]		Subordinate Securities	
Fair value at December 31, 2014	$56,801		$93,802		$460,990	
Expected life (in years) [2]	7		6		10	
Prepayment speed assumption (annual CPR) [2]	14	%	9	%	10	%
Decrease in fair value from:						
10% adverse change	$2,419		$3,999		$684	
25% adverse change	5,639		9,475		2,355	
Discount rate assumption [2]	11	%	8	%	5	%
Decrease in fair value from:						
100 basis point increase	$2,104		$4,214		$34,149	
200 basis point increase	4,102		8,091		64,474	
Credit loss assumption [2]	N/A		0.25	%	0.25	%
Decrease in fair value from:						
10% higher losses	N/A		$126		$3,169	
25% higher losses	N/A		299		7,841	

(1) Senior securities include $40 million and $88 million of interest only securities as of June 30, 2015 and December 31, 2014, respectively.

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

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Note 4. Principles of Consolidation - (continued)

Analysis of Third-Party VIEs
Third-party VIEs are securitization entities in 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 interests in third-party VIEs at June 30, 2015, grouped by security type.

Third-Party Sponsored VIE Summary

(Dollars in Thousands)	June 30, 2015
Residential Mortgage Backed Securities	
Senior	$452,041
Re-REMIC	169,084
Subordinate	169,928
Total Investments in Third-Party Sponsored VIEs	$791,053

We determined that we are not the primary beneficiary of any third-party VIEs, 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 solely 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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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at June 30, 2015 and December 31, 2014.

	June 30, 2015		December 31, 2014	
(In Thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	$890,623	$890,623	$1,341,032	$1,341,032
At lower of cost or fair value	1,458	1,655	1,488	1,669
Residential loans, held-for-investment (1)				
At fair value	2,394,399	2,394,399	581,668	581,668
At amortized cost	—	—	1,474,386	1,381,918
Commercial loans, held-for-sale	165,853	165,853	166,234	166,234
Commercial loans, held-for-investment				
At fair value	69,763	69,763	71,262	71,262
At amortized cost	315,715	321,038	329,431	334,876
Trading securities	116,141	116,141	111,606	111,606
Available-for-sale securities	1,041,458	1,041,458	1,267,624	1,267,624
MSRs	168,462	168,462	139,293	139,293
Cash and cash equivalents	226,426	226,426	269,730	269,730
Restricted cash	2,389	2,389	628	628
Accrued interest receivable	16,151	16,151	18,222	18,222
Derivative assets	26,252	26,252	16,417	16,417
REO (2)	4,410	5,081	4,391	4,703
Margin receivable (2)	71,392	71,392	65,374	65,374
FHLBC stock (2)	30,001	30,001	10,688	10,688
Guarantee asset (2)	6,417	6,417	7,201	7,201
Pledged collateral (2)	10,194	10,194	9,927	9,927
Liabilities				
Short-term debt	$1,367,062	$1,367,062	$1,793,825	$1,793,825
Accrued interest payable	8,291	8,291	8,502	8,502
Guarantee obligation	6,146	6,417	7,201	7,201
Derivative liabilities	54,109	54,109	58,331	58,331
ABS issued (1)				
Fair value	1,173,336	1,173,336	—	—
Amortized cost	88,786	89,231	1,545,119	1,446,605
FHLBC borrowings	882,122	882,122	495,860	495,860
Commercial secured borrowings	65,232	65,232	66,707	66,707
Convertible notes	492,500	475,700	492,500	492,188
Other long-term debt	139,500	101,138	139,500	101,835

(1)

Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment and ABS issued by consolidated Sequoia entities began to be recorded at fair value. See Note 3 for further discussion.

(2) These assets are included in other assets on our consolidated balance sheets.

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

During the three and six months ended June 30, 2015, we elected the fair value option for $36 million and $59 million of residential subordinate securities, $33 million and $33 million of residential senior securities, $2.78 billion and $5.18 billion of residential loans (principal balance), $258 million and $350 million of commercial loans (principal balance), and $32 million and $51 million of MSRs, respectively. We anticipate electing the fair value option for all future purchases of residential loans and commercial senior loans that we intend to sell to third parties or transfer to securitizations as well as for MSRs purchased or retained from sales of residential loans.

The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at June 30, 2015, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2015

June 30, 2015	Carrying	Fair Value Measurements Using		
(In Thousands)	Value	Level 1	Level 2	Level 3
Assets				
Residential loans	$3,285,022	$—	$248,157	$3,036,865
Commercial loans	235,616	—	—	235,616
Trading securities	116,141	—	—	116,141
Available-for-sale securities	1,041,458	—	—	1,041,458
Derivative assets	26,252	7,625	13,621	5,006
MSRs	168,462	—	—	168,462
Pledged collateral	10,194	10,194	—	—
FHLBC stock	30,001	30,001	—	—
Guarantee asset	6,417	—	—	6,417
Liabilities				
Derivative liabilities	54,109	5,726	43,983	4,400
Commercial secured borrowings	65,232	—	—	65,232
ABS issued	1,173,336	—	—	1,173,336

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

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the six months ended June 30, 2015.

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	Guarantee Asset	Derivatives (1)	Commercial Secured Borrowings	ABS Issued
Beginning balance - December 31, 2014	$1,677,984	$237,496	$111,606	$1,267,624	$139,293	$7,201	$1,119	$66,707	$—
Transfer to FVO (2)	1,370,699	—	—	—	—	—	—	—	1,302,216
Principal paydowns	(247,699)	(463)	(827)	(61,265)	—	—	—	(295)	(135,799)
Gains (losses) in net income, net	(6,661)	5,640	(7,187)	29,424	(3,842)	(855)	23,321	(1,204)	6,498
Unrealized losses in OCI, net	—	—	—	(7,050)	—	—	—	—	—
Acquisitions	2,519,029	350,384	92,006	14,788	51,217	—	—	—	—
Sales	(2,273,308)	(357,441)	(79,457)	(202,423)	(18,206)	—	—	—	—
Other settlements, net	(3,179)	—	—	360	—	71	(23,834)	24	421
Ending balance - June 30, 2015	$3,036,865	$235,616	$116,141	$1,041,458	$168,462	$6,417	$606	$65,232	$1,173,336

(1) For the purpose of this presentation, derivative assets and liabilities, which consist of loan purchase commitments, are presented on a net basis.

(2) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment in, and ABS issued by, consolidated financial entities are now recorded at fair value. See Note 3 for further discussion.

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 June 30, 2015 and 2014. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and six months ended June 30, 2015 and 2014 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2015 and 2014 Included in Net Income

Included in Net Income

(In Thousands)	Three Months Ended June 30, 2015	2014	Six Months Ended June 30, 2015	2014
Assets				
Residential loans at Redwood	$(7,508)	$11,755	$(5,441)	$11,964
Residential loans at consolidated Sequoia entities	2,476	—	5,331	—
Commercial loans	(1,565)	2,008	(56)	2,008
Trading securities	4,601	(9,257)	(5,254)	(13,688)
Available-for-sale securities	—	(264)	—	(377)
MSRs	21,296	(4,974)	10,277	(7,236)
Other assets - Guarantee asset	228	—	(700)	—
Liabilities				
Loan purchase commitments	(3,810)	1,707	(1,826)	1,707
Commercial secured borrowing	2,713	1,759	1,204	1,759
ABS issued	(3,552)	—	(6,498)	—

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

The following table presents information on assets recorded at fair value on a non-recurring basis at June 30, 2015. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at June 30, 2015.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at June 30, 2015

June 30, 2015	Carrying Value	Fair Value Measurements Using			Gain (Loss) for Three Months Ended	Six Months Ended
(In Thousands)		Level 1	Level 2	Level 3	June 30, 2015	June 30, 2015
Assets						
Residential loans, at lower of cost or fair value	$1,102	$—	$—	$1,102	$1	$1
REO	1,017	—	—	1,017	(170)	(175)

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

The following table presents the net gains and losses recorded in each line item of our consolidated statements of income for the three and six months ended June 30, 2015 and 2014.

Market Valuation Gains and Losses, Net

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Mortgage banking and investment activities, net				
Residential loans, at fair value	$(3,176)	$13,994	$(1,118)	$21,119
Consolidated Sequoia entities [1]	(684)	(321)	(1,777)	(464)
Residential loans held-for-investment, at Redwood	(5,885)	—	(3,907)	—
Commercial loans, at fair value	987	5,714	6,845	9,340
Trading securities	6,927	(8,733)	(7,162)	(13,164)
Risk management derivatives, net	4,645	(12,300)	(7,311)	(25,108)
Impairments on AFS securities	—	(264)	—	(377)
Guarantee asset	299	—	(784)	—
Loan purchase and forward sale commitments	1,054	3,582	19,309	3,590
Other investments	(71)	—	83	—
Total mortgage banking and investment activities, net[2]	$4,096	$1,672	$4,178	$(5,064)
MSR Income (loss), net				
MSRs	$15,675	$(5,553)	$(3,842)	$(8,265)
Risk management derivatives, net	(21,814)	—	(21,814)	—
Total MSR income (loss), net [3]	$(6,139)	$(5,553)	$(25,656)	$(8,265)
Total market valuation gains and losses, net	$(2,043)	$(3,881)	$(21,478)	$(13,329)

(1) On January 1, 2015, we adopted ASU 2014-13 and began to record the assets and liabilities of consolidated Sequoia entities at fair value. This amount includes the net change in fair value of the consolidated assets and liabilities of these entities, which include residential loans held-for-investment, REO, and ABS issued. This combined amount represents the estimated change in value of our retained interests in these entities. See Note 3 for further discussion.

(2) Mortgage banking and investment activities, net presented above does not include fee income or provisions for repurchases that is a component of mortgage banking and investment activities, net presented on our consolidated statements of income, as these amounts do not represent market valuation changes.

(3) MSR Income (loss), net presented above does not include net fee income or provisions for repurchases that are a component of MSR Income (loss), net on our consolidated statements of income.

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

At June 30, 2015, our valuation policy and process had not changed from those described in our Annual Report on Form 10-K. The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

Fair Value Methodology for Level 3 Financial Instruments

June 30, 2015 (Dollars in Thousands, except input values)	Fair Value	Unobservable Input	Range		Weighted Average	
Assets						
Residential loans, at fair value:						
Jumbo fixed rate loans uncommitted to sell	$1,267,521	IO Multiple	4.3 - 5.0	x	4.4	x
		Prepayment rate (Annual CPR)	12 - 15	%	14	%
		Senior spread to TBA price	$3.50 - $3.50		$3.50	
		Subordinate spread to swap rate	310 - 310	bps	310	bps
		Credit support	5 - 5	%	5	%
		Whole loan spread to TBA price	$2.90 - $4.15		$4.00	
Jumbo hybrid loans uncommitted to sell	181,279	Prepayment rate (Annual CPR)	15 - 15	%	15	%
		Spread to swap rate	125 - 160	bps	129	bps
Jumbo loans committed to sell	350,951	Committed Sales Price	$101 - $102		$102	
Loans held by consolidated Sequoia entities (1)	1,237,114	Liability price	N/A		N/A	
Residential loans, at lower of cost or fair value	1,102	Loss severity	13 - 30	%	20	%
Commercial loans, at fair value	235,616	Spread to swap rate	168 - 169	bps	168	bps
		Credit support	23 - 23	%	23	%
Trading and AFS securities	1,157,599	Discount rate	4 - 12	%	6	%
		Prepayment rate (Annual CPR)	1 - 35	%	13	%
		Default rate	0 - 35	%	8	%
		Loss severity	20 - 65	%	34	%

		Credit support	0 - 49	%	5	%
MSRs	168,462	Discount rate	8 - 11	%	10	%
		Prepayment rate (Annual CPR)	4 - 60	%	9	%
		Per loan annual cost to service	$72 - $82		$78	
Guarantee asset	6,417	Discount rate	11 - 11	%	11	%
		Prepayment rate (Annual CPR)	5 - 27	%	12	%
REO	1,017	Loss severity	19 - 76	%	55	%
Loan purchase commitments, net (2)	605	MSR Multiple	0 - 4	x	3.0	x
		Fallout rate	2 - 97	%	26	%
Liabilities						
ABS issued by consolidated Sequoia entities (1)	1,173,336	Discount rate	5 - 8	%	5	%
		Prepayment rate (Annual CPR)	0 - 31	%	13	%
		Default rate	0 - 12	%	6	%
		Loss severity	20 - 32	%	26	%
		Credit support	0 - 69	%	11	%
Commercial secured financing	65,232	Spread to swap rate	168 - 168	bps	168	bps
		Credit support	23 - 23	%	23	%

(1) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment in, and ABS issued by, consolidated Sequoia entities began to be recorded at fair value. In accordance with this new guidance, the fair value of the loans in these entities were based on the fair value of the liabilities issued by these entities, which we determined were more readily observable. See Note 3 for further discussion.

(2) For the purpose of this presentation, loan purchase commitment assets and liabilities are presented net.

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

Determination of Fair Value
A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed herein. We generally use both market comparable information and discounted cash flow modeling techniques to determine the fair value of our Level 3 assets and liabilities. Use of these techniques requires determination of relevant inputs and assumptions, some of which represent significant unobservable inputs as indicated in the preceding table. Accordingly, a significant increase or decrease in any of these inputs – such as anticipated credit losses, prepayment rates, interest rates, or other valuation assumptions – in isolation would likely result in a significantly lower or higher fair value measurement.
Residential loans
Estimated fair values for residential loans are determined using models that incorporate various observable inputs, including pricing information from recent securitizations and whole loan sales. Certain significant inputs in these models are considered unobservable and are therefore Level 3 in nature. Pricing inputs obtained from market securitization activity include indicative spreads to indexed TBA prices for senior RMBS and index swap rates, adjusted as necessary for current market conditions (Level 3). Pricing inputs obtained from market whole loan transaction activity include indicative spreads to indexed swap rates, adjusted as necessary for current market conditions (Level 3). Other observable inputs include Agency RMBS transactions, benchmark interest rates, and prepayment rates. These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed, or credit support assumptions.
Estimated fair values for conforming loans are determined based upon quoted market prices (Level 2). Conforming loans are mortgage loans that conform to Agency guidelines. As necessary, these values are adjusted for servicing value, market conditions and liquidity.
Commercial loans
Estimated fair values for senior commercial loans held-for-sale are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses include pricing points for current third-party Commercial Mortgage-Backed Securities (“CMBS”) sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for the securities for purchase into securitization (Level 2). The estimated fair value of our senior commercial loans would generally decrease based upon an increase in credit spreads or required credit support.
Estimated fair values for mezzanine commercial loans are determined by both market comparable pricing and discounted cash flow analysis valuation techniques (Level 3). Our discounted cash flow models utilize certain significant unobservable inputs including the underwritten net operating income and debt coverage ratio assumptions and actual performance relative to those underwritten metrics as well as estimated market discount rates. An increase in market discount rates would reduce the estimated fair value of the commercial loans.
Real estate securities
Real estate securities include residential, commercial, and other asset-backed securities that are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators that are factored into the analyses include bid/ask spreads, the amount and timing of credit losses, interest rates, and collateral prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows

(Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. The estimated fair value of our securities would generally decrease based upon an increase in default rates, serious delinquencies, or a decrease in prepayment rates or credit support.

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at June 30, 2015, we received dealer price indications on 81% of our securities, representing 92% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were within 1% of the aggregate average 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 swaps, swaptions, TBAs, financial futures, CMBX credit default index swaps, loan purchase commitments (LPCs), and forward sale commitments (FSCs). Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets. TBA and financial futures fair values are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions 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 can generally be verified and model selection does not involve significant management judgment (Level 2). LPC fair values are estimated based on quoted Agency MBS prices, estimates of the fair value of the MSRs we expect to retain in the sale of the loans, and the probability that the mortgage loan will be purchased (Level 3). FSC fair values are obtained using quoted Agency prices. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2).

For other derivatives, valuations are based on various factors such as liquidity, bid/ask spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management's best estimate is used (Level 3).

MSRs

MSRs include the rights to service jumbo and conforming residential 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 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 future MSR income, which is what we believe market participants would use to estimate fair value (Level 3). These discounted cash flow models utilize certain significant unobservable inputs including prepayment rate and discount rate assumptions. An increase in these unobservable inputs will reduce the estimated fair value of the MSRs.

As part of our MSR valuation process, we received a valuation estimate from a third-party valuations firm. In the aggregate, our internal valuation of the MSRs was less than 1% higher than the third-party valuation.

FHLBC Stock

Our Federal Home Loan Bank (FHLB) member subsidiary is required to purchase Federal Home Loan Bank of Chicago (FHLBC) stock under a borrowing agreement between our FHLBC member subsidiary and the FHLBC. Under this agreement, the stock is redeemable at face value, which represents the carrying value and fair value of the stock (Level 1).

Guarantee Asset

The guarantee asset represents the estimated fair value of cash flows we are contractually entitled to receive related to our risk sharing arrangement with Fannie Mae. Significant inputs in the valuation analysis are Level 3, due to the nature of this asset and the lack of market quotes. The fair value of the guarantee asset is determined using a discounted cash flow model, for which significant inputs include prepayment rates and market discount rate (Level 3). An increase in prepayment speed or market discount rate will reduce the estimated fair value of the guarantee asset.

Pledged Collateral

Pledged collateral consists of cash and U.S. Treasury securities held by a custodian in association with certain agreements we have entered into. Treasury securities are carried at their fair value, which is determined using quoted prices in active markets (Level 1).

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

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

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 2).

Short-term debt

Short-term debt includes our credit facilities that mature within one year. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 2).

ABS issued

ABS issued includes asset-backed securities issued through the Sequoia, Residential Resecuritization, and Commercial Securitization entities. These instruments are generally illiquid in nature and trade infrequently. 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. For ABS issued, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators factored into the analyses include bid/ask spreads, the amount and timing of collateral credit losses, interest rates, and collateral prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These liabilities would generally decrease in value (become a larger liability) if credit losses decreased or if the prepayment rate or discount rate were to increase.

FHLBC Borrowings

FHLBC borrowings include amounts borrowed from the FHLBC that are secured by residential mortgage loans. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 1).

Commercial secured borrowings

Commercial secured borrowings represent liabilities recognized as a result of transfers of portions of senior commercial mortgage loans to third parties that do not meet the criteria for sale treatment under GAAP and are accounted for as secured borrowings. Fair values for commercial secured borrowings are based on the fair values of the senior commercial loans associated with the borrowings (Level 3).

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

Convertible notes
Convertible notes include unsecured convertible and exchangeable senior notes. Fair values are determined using quoted prices in active markets (Level 2).
Trust preferred securities and subordinated notes
Estimated fair values of trust preferred securities and subordinated notes 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. The following table summarizes the classifications and carrying values of the residential loans owned at Redwood and at consolidated Sequoia entities at June 30, 2015 and December 31, 2014.

June 30, 2015			
(In Thousands)	Redwood	Sequoia [1]	Total
Held-for-sale			
Fair value - conforming	$248,157	$—	$248,157
Fair value - jumbo	642,466	—	642,466
Lower of cost or fair value	1,458	—	1,458
Held-for-investment			
Fair value - Jumbo	1,157,285	1,237,114	2,394,399
Total Residential Loans	$2,049,366	$1,237,114	$3,286,480

December 31, 2014			
(In Thousands)	Redwood	Sequoia [1]	Total
Held-for-sale			
Fair value - conforming	$244,714	$—	$244,714
Fair value - jumbo	1,096,317	—	1,096,317
Lower of cost or fair value	1,488	—	1,488
Held-for-investment			
Fair value - jumbo	581,668	—	581,668
At amortized cost	—	1,474,386	1,474,386
Total Residential Loans	$1,924,187	$1,474,386	$3,398,573

(1) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment at consolidated Sequoia entities began to be recorded at fair value. See Note 3 for further discussion.

At June 30, 2015, we owned mortgage servicing rights associated with $1.82 billion (principal balance) of consolidated residential loans purchased from third-party originators. The value of these MSRs is included in the carrying value of the associated loans on our balance sheet. We contract with a licensed sub-servicer that performs servicing functions for these loans.

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Note 6. Residential Loans - (continued)

Residential Loans Held-for-Sale
Residential Loans at Fair Value
At June 30, 2015, we owned 1,682 loans held-for-sale at fair value with an unpaid principal balance of $876 million, compared to 2,273 loans with an unpaid principal balance of $1.30 billion at December 31, 2014. At June 30, 2015 and December 31, 2014, none of these loans were greater than 90 days delinquent and none of the loans were in foreclosure.
During the three and six months ended June 30, 2015, we purchased $2.78 billion and $5.18 billion (principal balance) of loans, respectively, for which we elected the fair value option and recorded $3 million and $1 million of negative valuation adjustments, respectively, on residential loans held-for-sale at fair value through mortgage banking and investment activities, net, a component of our consolidated statements of income. During the three and six months ended June 30, 2015, we sold $2.74 billion and $4.93 billion (principal balance) of loans held-for-sale, respectively. At June 30, 2015 loans held-for-sale with a principal balance of $848 million were pledged as collateral under short-term borrowing agreements.
Residential Loans at Lower of Cost or Fair Value
At June 30, 2015 and December 31, 2014, we held nine residential loans at the lower of cost or fair value with $2 million in outstanding principal balance and a carrying value of $1 million for both periods.
Residential Loans Held-for-Investment at Fair Value
Residential Loans at Redwood
At June 30, 2015, we owned 1,519 held-for-investment loans at Redwood with an unpaid principal balance of $1.13 billion, compared to 803 loans with an unpaid principal balance of $566 million at December 31, 2014. At June 30, 2015 and December 31, 2014, one of these loans was greater than 90 days delinquent and none of the loans were in foreclosure.

During the three and six months ended June 30, 2015, we transferred loans with a principal balance of $213 million and $650 million and a fair value of $215 million and $662 million, respectively, from held-for-sale to held-for-investment, bringing the total amount of loans held-for-investment at fair value to $1.16 billion at June 30, 2015. During the three and six months ended June 30, 2015, we recorded negative $6 million and negative $4 million of valuation adjustments, respectively, on residential loans held-for-investment at fair value through mortgage banking and investment activities, net, a component of our consolidated statements of income. At June 30, 2015, $1.02 billion of these loans were pledged as collateral under a borrowing agreement with the FHLBC.
The outstanding loans held-for-investment at Redwood at June 30, 2015 were originated in 2014 and 2015 and the weighted average FICO score of borrowers backing these loans was 772 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 65% (at origination). At June 30, 2015, these loans were comprised of 91% fixed-rate loans with a weighted average coupon of 4.06%, and the remainder were hybrid loans with a weighted average coupon of 3.30%.
Residential Loans at Consolidated Sequoia Entities
On January 1, 2015, we eliminated $13 million of unamortized premium, net and $21 million of allowance for loan losses, related to loans at our consolidated Sequoia entities as part of our initial adoption of ASU 2014-13 and recorded a valuation adjustment on these loans to reduce the loan carrying values to their estimated fair values. See Note 3 for further discussion.
The following table details the carrying value for residential loans held-for-investment at consolidated Sequoia entities at June 30, 2015 and December 31, 2014.

Note 6. Residential Loans - (continued)

(In Thousands)	June 30, 2015	December 31, 2014
Principal balance	$1,343,333	$1,483,213
Unamortized premium, net	—	12,511
Allowance for loan losses	—	(21,338)
Valuation adjustment	(106,219)	—
Carrying value	$1,237,114	$1,474,386

At June 30, 2015, we owned 4,999 held-for-investment loans at consolidated Sequoia entities, as compared to 5,315 loans at December 31, 2014. The weighted average FICO score of borrowers backing these loans was 732 (at origination) and the weighted average LTV ratio of these loans was 66% (at origination). At June 30, 2015 and December 31, 2014, the unpaid principal balance of loans at consolidated Sequoia entities delinquent greater than 90 days was $66 million and $73 million, respectively, and the unpaid principal balance of loans in foreclosure was $36 million and $39 million, respectively. During the three and six months ended June 30, 2015, we recorded positive $2 million and $5 million, respectively, of net valuation adjustments on these loans through mortgage banking and investment activities, net on our consolidated statements of income.

Note 7. Commercial Loans

We invest in commercial loans that we originate as well as loans that we acquire from third-party originators. The following table summarizes the classifications and carrying value of commercial loans at June 30, 2015 and December 31, 2014.

(In Thousands)	June 30, 2015	December 31, 2014
Held-for-sale, at fair value	$165,853	$166,234
Held-for-investment		
At fair value	69,763	71,262
At amortized cost	315,715	329,431
Total Commercial Loans	$551,331	$566,927

Of the held-for-investment commercial loans at amortized cost shown above at June 30, 2015 and December 31, 2014, $182 million and $195 million, respectively, were financed through the Commercial Securitization entity.

Commercial Loans Held-for-Sale

Commercial loans held-for-sale include loans we originate and intend to sell to third parties. At June 30, 2015, we held 11 senior commercial mortgage loans at fair value, with an aggregate outstanding principal balance of $165 million and an aggregate fair value of $166 million. As of December 31, 2014, there were 13 senior commercial mortgage loans at fair value, with an aggregate outstanding principal balance of $163 million and an aggregate fair value of $166 million.

During the three and six months ended June 30, 2015, we acquired $258 million and $350 million (principal balance), respectively, of senior commercial loans for which we elected the fair value option and sold $146 million and $348 million (principal balance), respectively, of loans to third parties. During the three months ended June 30, 2015 and 2014, we recorded positive $1 million and positive $6 million, respectively, of valuation adjustments on senior commercial mortgage loans for which we elected the fair value option through mortgage banking and investment activities, net on our consolidated statements of income. During the six months ended June 30, 2015 and 2014, we recorded positive $7 million and positive $9 million, respectively, of valuation adjustments on senior commercial mortgage loans for which we elected the fair value option through mortgage banking and investment activities, net on our consolidated statements of income. At June 30, 2015, all commercial loans held-for-sale were current and loans with a principal balance of $60 million were pledged as collateral under short-term borrowing arrangements.

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Commercial Loans Held-for-Investment

Commercial Loans Held-for-Investment, at Fair Value

Commercial loans held-for-investment at fair value include senior mortgage loans for which we have elected the fair value option and have been split into senior A-notes and junior B-notes. Although the A-notes for each of the loans were sold, the transfers did not qualify for sale accounting treatment and we treated the sales as secured borrowings. At June 30, 2015, we held three of these A/B notes with an aggregate outstanding principal balance of $67 million and an aggregate fair value of $70 million. At December 31, 2014, we held three A/B notes, with an aggregate outstanding principal balance of $68 million and an aggregate fair value of $71 million. We carry the A-notes and associated secured commercial borrowings at the same fair values and the periodic valuation adjustments associated with these assets and liabilities offset through mortgage banking and investment activities, net on our consolidated statements of income. During the three and six months ended June 30, 2015 and 2014, there were no net changes in the fair value of the B-notes, in which we retain an actual economic interest. The carrying value of the B-notes at both June 30, 2015 and December 31, 2014 were $5 million.

Commercial Loans Held-for-Investment, at Amortized Cost

Commercial loans held-for-investment at amortized cost include loans we originate and preferred equity investments we make or, in either case, acquire from third parties. As of June 30, 2015, these loans primarily include 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 amortized cost at June 30, 2015 and December 31, 2014.

(In Thousands)	June 30, 2015	December 31, 2014
Principal balance	$327,592	$341,750
Unamortized discount, net	(4,476)	(4,862)
Recorded investment	323,116	336,888
Allowance for loan losses	(7,401)	(7,457)
Carrying Value	$315,715	$329,431

At both June 30, 2015 and December 31, 2014, we held 60 commercial loans held-for-investment at amortized cost. During the three and six months ended June 30, 2015, we originated or acquired $2 million and $9 million, respectively, of commercial loans held-for-investment at amortized cost. Of the $323 million of recorded investment in commercial loans held-for-investment at June 30, 2015, 3% was originated in 2015, 18% was originated in 2014, 15% was originated in 2013, 36% was originated in 2012, 24% was originated in 2011, and 4% was originated in 2010.

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.

Our methodology for assessing the adequacy of the allowance for loan losses includes a formal review of each commercial loan in the portfolio and the assignment of an internal impairment status. Based on the assigned impairment status, a loan is categorized as "Pass," "Watch List," or "Workout." The following table presents the principal balance of commercial loans held-for-investment by risk category.

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Note 7. Commercial Loans - (continued)

(In Thousands)	June 30, 2015	December 31, 2014
Pass	$302,075	$316,122
Watch list	25,517	25,628
Total Commercial Loans Held-for-Investment	$327,592	$341,750

Activity in the Allowance for Loan Losses on Commercial Loans

The following table summarizes the activity in the allowance for commercial loan losses for the three and six months ended June 30, 2015 and 2014.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Balance at beginning of period	$7,662	$8,028	$7,456	$7,373
Charge-offs, net	—	—	—	—
(Reversal of) provision for loan losses	(261)	289	(55)	944
Balance at End of Period	$7,401	$8,317	$7,401	$8,317

Commercial Loans Collectively Evaluated for Impairment

At June 30, 2015 and December 31, 2014, all of our commercial loans collectively evaluated for impairment were current. The following table summarizes the balances for loans collectively evaluated for impairment at June 30, 2015 and December 31, 2014.

(In Thousands)	June 30, 2015	December 31, 2014
Principal balance	$327,592	$341,750
Recorded investment	323,116	336,888
Related allowance	7,401	7,457

Commercial Loans Individually Evaluated for Impairment

We did not have any commercial loans individually evaluated for impairment at either June 30, 2015 or December 31, 2014.

Note 8. Real Estate Securities

We invest in residential mortgage-backed securities. The following table presents the fair values of our real estate securities by type at June 30, 2015 and December 31, 2014.

(In Thousands)	June 30, 2015	December 31, 2014
Trading	$116,141	$111,606
Available-for-sale	1,041,458	1,267,624
Total Real Estate Securities	$1,157,599	$1,379,230

Our real estate securities are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally 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 security interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior security interests, 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.

Note 8. Real Estate Securities - (continued)

Trading Securities

We elected the fair value option for certain securities and classify them as trading securities. At June 30, 2015, our trading securities included $47 million of interest-only securities, for which there is no principal balance, $22 million of senior securities and $47 million of subordinate securities. The unpaid principal balance of senior and subordinate securities classified as trading securities was $23 million and $61 million, respectively, at June 30, 2015. During the three and six months ended June 30, 2015, we acquired $71 million and $94 million (principal balance), respectively, of senior and subordinate securities for which we elected the fair value option and classified as trading, and sold $35 million and $37 million of such securities, respectively. During the three months ended June 30, 2015 and 2014, we recorded positive $7 million and negative $9 million, respectively, of valuation adjustments on trading securities, included in mortgage banking and investment activities, net on our consolidated income statements. During the six months ended June 30, 2015 and 2014, we recorded negative $7 million and negative $13 million, respectively, of valuation adjustments on trading securities, included in mortgage banking and investment activities, net on our consolidated statements of income.

The following table presents trading securities by collateral type at June 30, 2015 and December 31, 2014.

(In Thousands)	June 30, 2015	December 31, 2014
Senior Securities		
Prime	$62,427	$93,802
Non-prime	6,705	7,951
Total Senior Securities	69,132	101,753
Prime Subordinate Securities	47,009	9,853
Total Trading Securities	$116,141	$111,606

AFS Securities

The following table presents the fair value of our available-for-sale securities held at Redwood by collateral type at June 30, 2015 and December 31, 2014.

(In Thousands)	June 30, 2015	December 31, 2014
Senior Securities		
Prime	$278,960	$307,813
Non-prime	166,376	179,744
Total Senior Securities	445,336	487,557
Re-REMIC Securities	169,084	168,347
Subordinate Securities		
Prime Mezzanine (1)	257,263	448,838
Subordinate (2)	169,775	162,882
Total Subordinate Securities	427,038	611,720
Total AFS Securities	$1,041,458	$1,267,624

(1) Mezzanine includes securities initially rated AA, A and BBB- and issued in 2012 or later.

(2) Subordinate securities includes less than $1 million of non-prime securities at both June 30, 2015, and December 31, 2014.

The senior securities shown above at June 30, 2015 and December 31, 2014, included $88 million and $105 million, respectively, of prime securities, and $107 million and $117 million, respectively, of non-prime securities that were financed through the Residential Resecuritization entity, as discussed in Note 4. As of June 30, 2015 AFS securities with a carrying value of $535 million were pledged as collateral under short-term borrowing agreements. See Note 12

for additional information on short-term debt.
During the three and six months ended June 30, 2015, we purchased $5 million and $15 million of AFS securities, respectively, and sold $112 million and $202 million of AFS securities, respectively, which resulted in realized gains of $6 million and $10 million, respectively. During the three months ended June 30, 2014, we purchased $77 million of AFS securities and sold $1 million.

Note 8. Real Estate Securities - (continued)

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

At June 30, 2015, there were $6 million of AFS securities with contractual maturities less than five years, $2 million of AFS securities with contractual maturities greater than five years but less than 10 years, and the remainder of our AFS securities had contractual maturities greater than 10 years.

The following table presents the components of carrying value (which equals fair value) of AFS securities at June 30, 2015 and December 31, 2014.

Carrying Value of AFS Securities

June 30, 2015	Senior				
(In Thousands)	Prime	Non-prime	Re-REMIC	Subordinate	Total
Principal balance	$282,921	$182,719	$193,221	$535,511	$1,194,372
Credit reserve	(2,650)	(9,175)	(13,071)	(36,804)	(61,700)
Unamortized discount, net	(30,401)	(27,533)	(75,658)	(139,527)	(273,119)
Amortized cost	249,870	146,011	104,492	359,180	859,553
Gross unrealized gains	31,196	20,550	64,592	68,519	184,857
Gross unrealized losses	(2,106)	(185)	—	(661)	(2,952)
Carrying Value	$278,960	$166,376	$169,084	$427,038	$1,041,458
December 31, 2014	Senior				
(In Thousands)	Prime	Non-prime	Re-REMIC	Subordinate	Total
Principal balance	$311,573	$196,258	$195,098	$742,150	$1,445,079
Credit reserve	(3,660)	(9,644)	(15,202)	(41,561)	(70,067)
Unamortized discount, net	(34,782)	(31,491)	(79,611)	(150,458)	(296,342)
Amortized cost	273,131	155,123	100,285	550,131	1,078,670
Gross unrealized gains	35,980	24,682	68,062	63,026	191,750
Gross unrealized losses	(1,298)	(61)	—	(1,437)	(2,796)
Carrying Value	$307,813	$179,744	$168,347	$611,720	$1,267,624

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Note 8. Real Estate Securities - (continued)

The following table presents the changes for the three and six months ended June 30, 2015, in unamortized discount and designated credit reserves on residential AFS securities.

Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

	Three Months Ended June 30, 2015		Six Months Ended June 30, 2015	
(In Thousands)	Credit Reserve	Unamortized Discount, Net	Credit Reserve	Unamortized Discount, Net
Beginning balance	$63,584	$286,382	$70,067	$296,342
Amortization of net discount	—	(9,324)	—	(19,162)
Realized credit losses	(2,769)	—	(5,714)	—
Acquisitions	858	3,033	858	5,705
Sales, calls, other	—	(6,945)	—	(13,277)
Impairments	—	—	—	—
Transfers to (release of) credit reserves, net	27	(27)	(3,511)	3,511
Ending Balance	$61,700	$273,119	$61,700	$273,119

AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at June 30, 2015 and December 31, 2014.

	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
(In Thousands)	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
June 30, 2015	$98,390	$(1,263)	$97,127	$74,537	$(1,689)	$72,848
December 31, 2014	126,681	(1,374)	125,307	70,676	(1,422)	69,254

At June 30, 2015, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 260 AFS securities, of which 29 were in an unrealized loss position and 13 were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2014, our consolidated balance sheet included 290 AFS securities, of which 31 were in an unrealized loss position and 10 were in a continuous unrealized loss position for 12 consecutive months or longer.

Evaluating AFS Securities for Other-than-Temporary Impairments

Gross unrealized losses on our AFS securities were $3 million at June 30, 2015. We evaluate all securities in an unrealized loss position to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). At June 30, 2015, we did not intend to sell any of our AFS securities that were in an unrealized loss position, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity. We review our AFS securities that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent security performance and expected future performance of the underlying collateral.

During the three and six months ended June 30, 2015, we recognized no OTTI losses related to our AFS securities. AFS securities for which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. In determining our estimate of cash flows for AFS securities we may consider factors such as structural credit enhancement, past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, which are informed by prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, and geographic concentrations, as well as general market assessments. Changes in our evaluation of these factors impacted the cash flows expected to be collected at the OTTI assessment date and were used to determine if there were credit-related

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Note 8. Real Estate Securities - (continued)

adverse cash flows and if so, the amount of credit related losses. Significant judgment is used in both our analysis of the expected cash flows for our AFS securities and any determination of the credit loss component of OTTI.
The table below summarizes the significant valuation assumptions we used for our AFS securities in unrealized loss positions at June 30, 2015.
Significant Valuation Assumptions

	Range for Securities			
June 30, 2015	Prime		Non-prime	
Prepayment rates	8 - 16	%	8 - 12	%
Projected losses	1 - 21	%	14 - 18	%

The following table details the activity related to the credit loss component of OTTI (i.e., OTTI recognized through earnings) for AFS securities held at June 30, 2015 and 2014, for which a portion of an OTTI was recognized in other comprehensive income.
Activity of the Credit Component of Other-than-Temporary Impairments

	Three Months Ended June 30,				Six Months Ended June 30,			
(In Thousands)	2015		2014		2015		2014	
Balance at beginning of period	$32,949		$35,786		$33,849		$37,149	
Additions								
Initial credit impairments	—		190		—		261	
Subsequent credit impairments	—		28		—		70	
Reductions								
Securities sold, or expected to sell	(253	)	(904	)	(348	)	(904	)
Securities with no outstanding principal at period end	—		(844	)	(805	)	(2,320	)
Balance at End of Period	$32,696		$34,256		$32,696		$34,256	

Gross Realized Gains and Losses on AFS Securities
Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains and losses on sales and calls of AFS securities for the three and six months ended June 30, 2015 and 2014.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Gross realized gains - sales	$5,956	$992	$10,262	$992
Gross realized gains - calls	360	—	360	987
Gross realized losses - sales	—	—	—	—
Gross realized losses - calls	—	—	—	—
Total Realized Gains on Sales and Calls of AFS Securities, net	$6,316	$992	$10,622	$1,979

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Note 9. Mortgage Servicing Rights

We invest in mortgage servicing rights associated with residential mortgage loans and contract with a licensed sub-servicer to perform all servicing functions for these loans. The following table presents the fair value of MSRs and the aggregate principal amounts of associated loans as of June 30, 2015 and December 31, 2014.

	June 30, 2015		December 31, 2014	
(In Thousands)	MSR Fair Value	Associated Principal	MSR Fair Value	Associated Principal
Mortgage Servicing Rights				
Conforming Loans	$101,458	$8,917,808	$81,301	$7,705,146
Jumbo Loans	67,004	6,148,268	57,992	5,962,784
Total Mortgage Servicing Rights	$168,462	$15,066,076	$139,293	$13,667,930

MSR Activity

The following table presents activity for MSRs for the three and six months ended June 30, 2015 and 2014.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Balance at beginning of period	$120,324	$64,971	$139,293	$64,824
Additions	32,463	11,807	51,217	14,666
Sales	—	—	(18,206)	—
Changes in fair value due to:				
Changes in assumptions (1)	19,168	(3,553)	5,132	(4,678)
Other changes (2)	(3,493)	(2,000)	(8,974)	(3,587)
Balance at End of Period	$168,462	$71,225	$168,462	$71,225

(1) Primarily reflects changes in prepayment assumptions due to changes in market interest rates.
(2) Represents changes due to realization of expected cash flows.

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Note 9. Mortgage Servicing Rights - (continued)

MSR Additions

We make investments in MSRs through the retention of servicing rights associated with the residential mortgage loans that we acquire and subsequently transfer to third parties or through the direct acquisition of MSRs sold by third parties. We hold our MSR investments at a taxable REIT subsidiary. The following table details the retention and purchase of MSRs during the three and six months ended June 30, 2015.

(In Thousands)	Three Months Ended June 30, 2015		Six Months Ended June 30, 2015	
	MSR Fair Value	Associated Principal	MSR Fair Value	Associated Principal
Jumbo MSR additions:				
From securitization	$6,002	$607,402	$7,874	$835,254
From loan sales	172	16,122	264	26,267
Total jumbo MSR additions	6,174	623,524	8,138	861,521
Conforming MSR additions:				
From loan sales	$14,990	$1,348,871	$28,701	$2,701,529
From purchases	11,299	1,025,576	14,378	1,343,914
Total conforming MSR additions	26,289	2,374,447	43,079	4,045,443
Total MSR additions	$32,463	$2,997,971	$51,217	$4,906,964

MSR Income (Loss), net

The following table presents the components of our MSR income.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Servicing income				
Income	$8,454	$4,064	$18,170	$7,697
Cost of sub-servicer	(1,162)	(288)	(2,391)	(603)
Net servicing income	7,292	3,776	15,779	7,094
Market valuation changes of MSRs	15,675	(5,553)	(3,842)	(8,265)
Market valuation changes of associated derivatives (1)	(21,814)	—	(21,814)	—
MSR provision for repurchases	(323)	—	(217)	—
MSR income (loss), net	$830	$(1,777)	$(10,094)	$(1,171)

(1) In the second quarter of 2015, we began to identify specific derivatives used to hedge the exposure of our MSRs to changes in market interest rates. See Note 2 for additional detail.

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Note 10. Derivative Financial Instruments

The following table presents the fair value and notional amount of our derivative financial instruments at June 30, 2015 and December 31, 2014.

	June 30, 2015		December 31, 2014	
(In Thousands)	Fair Value	Notional Amount	Fair Value	Notional Amount
Assets - Risk Management Derivatives				
Interest rate swaps	$294	$50,000	$—	$—
TBAs	7,625	1,246,400	6,654	1,074,000
Futures	—	—	—	—
Swaptions	8,726	1,185,000	7,006	575,000
Credit default index swaps	3,792	100,000	1,597	50,000
Assets - Other Derivatives				
Loan purchase commitments	5,006	777,361	1,160	288,467
Loan forward sale commitments	809	155,319	—	—
Total Assets	$26,252	$3,514,080	$16,417	$1,987,467
Liabilities - Cash Flow Hedges				
Interest rate swaps	$(39,810)	$139,500	$(46,845)	$139,500
Liabilities - Risk Management Derivatives				
Interest rate swaps	(4,172)	532,500	(1,328)	206,000
TBAs	(5,466)	1,290,500	(9,506)	1,110,000
Futures	(260)	54,000	(372)	90,000
Liabilities - Other Derivatives				
Loan purchase commitments	(4,401)	861,436	(41)	27,324
Loan forward sale commitments	—	—	(239)	102,793
Total Liabilities	$(54,109)	$2,877,936	$(58,331)	$1,675,617
Total Derivative Financial Instruments, Net	$(27,857)	$6,392,016	$(41,914)	$3,663,084

Risk Management Derivatives

To manage, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheet, we may enter into derivative contracts. At June 30, 2015, we were party to swaps and swaptions with an aggregate notional amount of $1.9 billion, TBA contracts sold with an aggregate notional amount of $2.5 billion, and financial futures contracts with an aggregate notional amount of $54 million. Net market valuation adjustments on risk management derivatives were negative $17 million and negative $29 million for the three and six months ended June 30, 2015, respectively. Net market valuation adjustments on risk management derivatives were negative $12 million and negative $25 million for the three and six months ended June 30, 2014, respectively. These net market valuation adjustments are recorded in mortgage banking and investment activities, net on our consolidated statements of income.

Loan Purchase and Forward Sale Commitments

LPCs and FSCs that qualify as derivatives are recorded at their estimated fair values. Net valuation adjustments on LPCs and FSCs were positive $1 million and positive $19 million for the three and six months ended June 30, 2015, respectively, and are reported through our consolidated statements of income in mortgage banking and investment activities, net.

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Note 10. Derivative Financial Instruments - (continued)

Derivatives Designated as Cash Flow Hedges

To manage 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 certain interest rate swaps as cash flow hedges with an aggregate notional balance of $140 million.

For the three months ended June 30, 2015 and 2014, changes in the values of designated cash flow hedges were positive $15 million and negative $5 million, respectively, and were recorded in accumulated other comprehensive income, a component of equity. For the six months ended June 30, 2015 and 2014, changes in the values of designated cash flow hedges were positive $7 million and negative $14 million, respectively. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was $39 million and $46 million at June 30, 2015 and December 31, 2014, respectively. For both the three and six months ended June 30, 2015 and 2014, we reclassified less than $100 thousand of unrealized losses on derivatives to interest expense. Accumulated other comprehensive loss of less than $1 million will be amortized into interest expense, a component of our consolidated income statements, over the remaining life of the hedge liabilities.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and six months ended June 30, 2015 and 2014.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Net interest expense on cash interest rate agreements	$(1,475)	$(1,490)	$(2,959)	$(2,978)
Realized expense due to ineffective portion of cash flow hedges	—	—	—	—
Realized net losses reclassified from other comprehensive income	(26)	(39)	(57)	(99)
Total Interest Expense	$(1,501)	$(1,529)	$(3,016)	$(3,077)

Derivative Counterparty Credit Risk

As discussed in our Annual Report on Form 10-K, we consider counterparty risk as part of our fair value assessments of all derivative financial instruments. At June 30, 2015, we assessed this risk as remote and did not record a specific valuation adjustment.

At June 30, 2015, we had outstanding derivative agreements with seven counterparties (other than clearinghouses) and were in compliance with ISDA agreements governing our open derivative positions.

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Note 11. Other Assets and Liabilities
Other Assets
Other assets at June 30, 2015 and December 31, 2014, are summarized in the following table.

(In Thousands)	June 30, 2015	December 31, 2014
Margin receivable	$71,392	$65,374
FHLBC stock	30,001	10,688
Pledged collateral	10,194	9,927
Guarantee asset	6,417	7,201
Investment receivable	5,378	1,103
Deposits	5,000	5,000
Fixed assets and leasehold improvements (1)	4,442	3,008
REO	4,410	4,391
Income tax receivables	3,278	175
Prepaid expenses	3,031	3,372
Other	4,077	3,657
Total Other Assets	$147,620	$113,896

(1) Fixed assets and leasehold improvements have a basis of $7 million and accumulated depreciation of $4 million at June 30, 2015.

Accrued Expenses and Other Liabilities
Accrued expenses and other liabilities at June 30, 2015 and December 31, 2014 are summarized in the following table.

(In Thousands)	June 30, 2015	December 31, 2014
Accrued compensation	$11,927	$19,273
Margin payable	$10,156	$6,455
Guarantee obligation	6,146	7,201
Current accounts payable	5,446	2,112
Residential loan and MSR repurchase reserve	5,083	3,724
Accrued operating expenses	3,501	3,334
Legal reserve	2,000	2,000
Income tax payable	221	—
Other	5,445	8,145
Total Other Liabilities	$49,925	$52,244

Margin Receivable and Payable
Margin receivable and payable resulted from margin calls between us and our derivatives, master repurchase agreements, and warehouse facilities counterparties whereby we or the counterparty were required to post collateral.
Investment Receivable and Unsettled Trades
In accordance with our policy to record purchases and sales of securities on the trade date, if the trade and settlement of a purchase or sale crosses over a quarterly reporting period, we will record an investment receivable for sales and an unsettled trades liability for purchases.

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Note 11. Other Assets and Liabilities - (continued)

Guarantee Asset, Pledged Collateral, and Guarantee Obligation

The pledged collateral, guarantee asset, and guarantee obligation presented in the tables above are related to the risk sharing arrangement we entered into with Fannie Mae in the fourth quarter of 2014. See Note 15 for additional information on the on the risk sharing arrangement.

REO

The carrying value of REO at June 30, 2015, was $4 million, which includes the net effect of $5 million related to transfers into REO during the six months ended June 30, 2015, offset by $3 million of REO liquidations, and $2 million of negative market valuation adjustments. At June 30, 2015 and December 31, 2014, there were 18 and 22 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Sequoia entities.

See Note 15 for additional information on the legal and residential repurchase reserves.

Note 12. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At June 30, 2015, we had outstanding agreements with several 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 and in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2014.

The table below summarizes the facilities that are available to us and the balances of short-term debt at June 30, 2015 and December 31, 2014 by the type of collateral securing the debt.

Short-Term Debt

	June 30, 2015			
(Dollars in Thousands)	Number of Facilities	Outstanding	Limit	Maturity
Collateral Type				
Residential loans	5	$776,824	$1,800,000	7/2015-6/2016
Commercial loans	3	96,849	450,000	9/2015-10/2016
Real estate securities	8	493,389	—	7/2015-9/2015
Total	16	$1,367,062		

	December 31, 2014			
(Dollars in Thousands)	Number of Facilities	Outstanding	Limit	Maturity
Collateral Type				
Residential loans	5	$1,076,188	$1,550,000	2/2015-12/2015
Commercial loans	3	109,128	400,000	4/2015-10/2016
Real estate securities	9	608,509	—	1/2015-3/2015
Total	17	$1,793,825		

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At June 30, 2015, all of these borrowings were under uncommitted facilities and were due within 364 days (or less) of the borrowing date.

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Note 12. Short-Term Debt - (continued)

The fair value of residential loans, commercial loans, and real estate securities pledged as collateral was $860 million, $143 million, and $615 million, respectively, at June 30, 2015 and $1.22 billion, $161 million, and $762 million, respectively, at December 31, 2014. For the three and six months ended June 30, 2015, the average balance of short-term debt was $1.38 billion and $1.48 billion, respectively. At both June 30, 2015 and December 31, 2014, accrued interest payable on short-term debt was $2 million.

We also maintain a $10 million committed line of credit with a financial institution that is secured by our pledge of certain mortgage-backed securities we own. At both June 30, 2015 and December 31, 2014, we had no outstanding borrowings on this facility.

Characteristics of Short-Term Debt

The table below summarizes short-term debt by weighted average interest rates and by collateral type at June 30, 2015.

	June 30, 2015			
(Dollars in Thousands)	Amount Borrowed	Weighted Average Interest Rate		Weighted Average Days Until Maturity
Collateral Type				
Residential loan collateral	$776,824	1.73	%	233
Commercial loan collateral	96,849	3.92	%	185
Real estate securities collateral	493,389	1.43	%	22
Total Short-Term Debt	$1,367,062	1.78	%	154

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of short-term debt at June 30, 2015 and December 31, 2014.

	June 30, 2015			
(In Thousands)	Within 30 days	31 to 90 days	Over 90 days	Total
Collateral Type				
Residential loans	$—	$—	$776,824	$776,824
Commercial loans	—	52,224	44,625	96,849
Real estate securities	363,099	127,864	2,426	493,389
Total Short-Term Debt	$363,099	$180,088	$823,875	$1,367,062

	December 31, 2014			
(In Thousands)	Within 30 days	31 to 90 days	Over 90 days	Total
Collateral Type				
Residential loans	$—	$354,064	$722,124	$1,076,188
Commercial loans	—	—	109,128	109,128
Real estate securities	515,552	92,957	—	608,509
Total Short-Term Debt	$515,552	$447,021	$831,252	$1,793,825

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Note 13. Asset-Backed Securities Issued

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

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

The carrying values of ABS issued by consolidated securitization entities we sponsored at June 30, 2015 and December 31, 2014, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

	June 30, 2015			
(Dollars in Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Certificates with principal balance	$1,289,032	$18,872	$69,914	$1,377,818
Interest-only certificates	5,011	—	—	5,011
Market valuation adjustments [(1)]	(120,707)	—	—	(120,707)
Total ABS Issued	$1,173,336	$18,872	$69,914	$1,262,122
Range of weighted average interest rates, by series	0.39% to 4.33%	2.18%	5.62%	
Stated maturities	2017-2041	2046	2018	
Number of series	24	1	1	

(1) Upon adoption of ASU 2014-13 on January 1, 2015, we began to account for ABS issued by consolidated Sequoia entities at fair value. See Note 3 for additional information.

	December 31, 2014			
(Dollars in Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Certificates with principal balance	$1,427,056	$45,044	$83,313	$1,555,413
Interest-only certificates	2,079	—	—	2,079
Unamortized discount	(12,373)	—	—	(12,373)
Total ABS Issued	$1,416,762	$45,044	$83,313	$1,545,119
Range of weighted average interest rates, by series	0.36% to 4.27%	2.16%	5.62%	
Stated maturities	2014 - 2041	2046	2018	
Number of series	24	1	1	

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The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its stated maturity. At June 30, 2015, $1.25 billion of ABS issued ($1.36 billion principal balance) had contractual maturities beyond five years and $8 million of ABS issued ($16 million principal balance) had contractual maturities of less than one year. Amortization of Commercial Securitization and Residential Resecuritization deferred ABS issuance costs were less than $1 million and $1 million for the three and six months ended June 30, 2015 and 2014, respectively. The following table summarizes the accrued interest payable on ABS issued at June 30, 2015 and December 31, 2014. Interest due on consolidated ABS issued is payable monthly.

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	June 30, 2015	December 31, 2014
Sequoia	$797	$976
Residential Resecuritization	2	5
Commercial Securitization	328	390
Total Accrued Interest Payable on ABS Issued	$1,127	$1,371

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at June 30, 2015 and December 31, 2014.

Collateral for Asset-Backed Securities Issued

	June 30, 2015			
(In Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Residential loans	$1,237,114	$—	$—	$1,237,114
Commercial loans	—	—	182,184	182,184
Real estate securities	—	195,278	—	195,278
Restricted cash	147	—	139	286
Accrued interest receivable	1,589	409	1,367	3,365
REO	4,409	—	—	4,409
Total Collateral for ABS Issued	$1,243,259	$195,687	$183,690	$1,622,636

	December 31, 2014			
(In Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Residential loans	$1,474,386	$—	$—	$1,474,386
Commercial loans	—	—	194,991	194,991
Real estate securities	—	221,676	—	221,676
Restricted cash	147	43	137	327
Accrued interest receivable	2,359	477	1,511	4,347
REO	4,391	—	—	4,391
Total Collateral for ABS Issued	$1,481,283	$222,196	$196,639	$1,900,118

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Note 14. Long-Term Debt

FHLBC Borrowings

In July 2014, our FHLB member subsidiary entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. As of June 30, 2015, under this agreement, our subsidiary could incur borrowings up to $1 billion, also referred to as “advances,” from the FHLBC secured by eligible collateral, including, but not limited to residential mortgage loans and residential mortgage-backed securities. This borrowing agreement is uncommitted, which means that any request we make to borrow funds may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under this agreement. During the three and six months ended June 30, 2015, our FHLB-member subsidiary borrowed an additional $31 million and $386 million, respectively, under this agreement. At June 30, 2015, $882 million of advances were outstanding under this agreement with a weighted average interest rate of 0.23% and a weighted average maturity of 6 years. Advances under this agreement incur interest charges based on a specified margin over the FHLBC’s 13-week discount note rate, which resets every 13 weeks. These advances were secured by residential mortgage loans with a fair value of $1.00 billion at June 30, 2015. This agreement also requires our subsidiary to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of outstanding advances. At June 30, 2015, our subsidiary held $30 million of FHLBC stock that is included in other assets in our consolidated balance sheets. During July of 2015, the FHLBC approved an increase to our FHLB-member subsidiary's uncommitted borrowing capacity, bringing our subsidiary's total uncommitted borrowing capacity with the FHLBC to $1.4 billion.

Commercial Secured Borrowing

At June 30, 2015, we had commercial secured borrowings of $65 million resulting from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. We bifurcated certain of our senior commercial mortgage loans into a senior portion that was sold to a third party and a junior portion that we retained as an investment. Although GAAP requires us to record a secured borrowing liability when we receive cash from selling the senior portion of the loan, the liability has no economic substance to us in that it does not require periodic interest payments and has no maturity. For each commercial secured borrowing, at such time that the associated senior portion of the loan is repaid or we sell our retained junior portion, the secured borrowing liability and associated senior portion of the loan would be derecognized from our balance sheet.

Convertible Notes

In November 2014, RWT Holdings, Inc., a wholly-owned subsidiary of Redwood Trust, Inc., issued $205 million principal amount of 5.625% exchangeable senior notes due 2019. These exchangeable notes require semi-annual interest payments at a fixed coupon rate of 5.625% until maturity or exchange, which will be no later than November 15, 2019. After deducting the underwriting discount and offering costs, we received $198 million of net proceeds. Including amortization of deferred securities issuance costs, the interest expense yield on these exchangeable notes was 6.58% and 6.51% for the three and six months ended June 30, 2015, respectively. At June 30, 2015, the accrued interest payable balance on this debt was $2 million and the unamortized deferred issuance costs were $6 million. At June 30, 2015, these notes were exchangeable at the option of the holder at an exchange rate of 46.1798 common shares per $1,000 principal amount of exchangeable senior notes (equivalent to an exchange price of $21.65 per common share). Upon exchange of these notes by a holder, the holder will receive shares of our common stock.

In March 2013, we issued $288 million principal amount of 4.625% convertible senior notes due 2018. These convertible notes require semi-annual interest payments at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. After deducting the underwriting discount and offering costs, we received $279 million of net proceeds. Including amortization of deferred securities issuance costs, the interest expense yield on these convertible notes was 5.41% and 5.39% for the three and six months ended June 30, 2015, respectively. At June 30, 2015, the accrued interest payable balance on this debt was $3 million and the unamortized deferred issuance costs were $5 million. At June 30, 2015, these notes were convertible at the option of the holder at a conversion rate of 41.1320 common shares per $1,000 principal amount of convertible senior notes (equivalent to a conversion price of $24.31 per common share). Upon conversion of these notes by a holder, the holder will receive shares of our common stock.

Trust Preferred Securities and Subordinated Notes

At June 30, 2015, we had trust preferred securities and subordinated notes outstanding of $100 million and $40 million, respectively. The interest expense yield on both our trust preferred securities and subordinated notes was 2.63% and 2.67% for the three months ended

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June 30, 2015 and 2014, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on both our trust preferred securities and subordinated notes was 6.85% and 6.89% for the three months ended June 30, 2015 and 2014, respectively.

The interest expense yield on both our trust preferred securities and subordinated notes was 2.58% and 2.57% for the six months ended June 30, 2015 and 2014, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on both our trust preferred securities and subordinated notes was 6.85% and 6.87% for the six months ended June 30, 2015 and 2014, respectively.

At both June 30, 2015 and December 31, 2014, the accrued interest payable balance on our trust preferred securities and subordinated notes was less than $1 million. Under the terms of this debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is pari passu or subordinate to this debt.

Note 15. Commitments and Contingencies

Lease Commitments

At June 30, 2015, we were obligated under nine non-cancelable operating leases with expiration dates through 2021 for $12 million of cumulative lease payments. Operating lease expense was $1 million for both of the six months ended June 30, 2015 and 2014.

The following table presents our future lease commitments at June 30, 2015.

Future Lease Commitments by Year

(In Thousands)	June 30, 2015
2015 (6 months)	$1,400
2016	2,838
2017	2,879
2018	1,827
2019	1,189
2020 and thereafter	1,495
Total Lease Commitments	$11,628

Loss Contingencies — Risk Sharing

In the fourth quarter of 2014, we entered into a risk-sharing arrangement with Fannie Mae. Under this arrangement we committed to assume the first one percent of losses realized on a reference pool of residential mortgage loans originated in 2014 that we acquired and then sold to Fannie Mae during the fourth quarter of 2014. During the 10 year term of the arrangement, we receive monthly cash payments from Fannie Mae based on the monthly outstanding unpaid principal balance of the reference pool of loans. Additionally, under this arrangement we are required to maintain collateral with a third party custodian sufficient to cover our maximum loss exposure throughout the term of the arrangement. To the extent approved losses are incurred, the custodian will transfer collateral to Fannie Mae. As a result of this transaction we recorded “pledged collateral” and a “guarantee asset” in the other assets line item, and a “guarantee obligation” in the other liabilities line item, on our consolidated balance sheets.

The guarantee obligation represents our commitment to assume losses under the arrangement, which at inception was recorded at fair value based on the fair value of the guarantee asset. We are amortizing the guarantee obligation over the 10 year term of the arrangement based on changes in the outstanding unpaid principal balance of loans in the reference pool. In addition, each period we assess the need for a separate loss allowance related to this arrangement, based on our estimate of credit losses inherent in the reference pool of loans.

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Note 15. Commitments and Contingencies - (continued)

To determine the loss allowance, we assess inherent losses in the reference pool of loans by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults). As of June 30, 2015, we determined a loss allowance was not required.

Income from cash payments received under the risk sharing arrangement and income related to the amortization of the guarantee obligation are recorded in other income, and market valuation changes of the guarantee asset are recorded in mortgage banking and investment activities, net, on our consolidated statements of income. For the three and six months ended June 30, 2015, other income related to this transaction was $1 million and $2 million, respectively, and market valuation changes were less than $1 million and negative $1 million, respectively.

All of the loans in the reference pool subject to the guarantee were originated in 2014 and at June 30, 2015, the loans had an unpaid principal balance of $874 million and an original weighted average FICO score of 762 (at origination) and LTV of 75% (at origination). At June 30, 2015, $2 million of the outstanding principal balance was 30 days or more delinquent and less than $1 million of the loans were 90 days or more delinquent or in foreclosure. At June 30, 2015, the maximum potential amount of future payments we could be required to make under this obligation was $10 million and this amount was fully collateralized by assets we have transferred to a custodian and are presented as pledged collateral in other assets on our consolidated balance sheets. We have no recourse to any third parties that would allow us to recover any amounts related to this guarantee obligation. As of June 30, 2015, we have not incurred any losses under this agreement.

Our consolidated balance sheets include assets of special purpose entities (SPEs) that can only be used to settle obligations of these SPEs and liabilities of SPEs for which creditors do not have recourse to Redwood Trust, Inc. or its affiliates. The SPEs exist for the purpose of engaging in risk sharing arrangements with Fannie Mae and Freddie Mac. At June 30, 2015 and December 31, 2014, assets of such SPEs totaled $17 million and $19 million, respectively, and liabilities of such SPEs totaled $6 million and $7 million, respectively.

Loss Contingencies — Residential Repurchase Reserve

We maintain a repurchase reserve for potential obligations arising from representation and warranty violations related to residential loans we have sold to securitization trusts or third parties and for conforming residential loans associated with MSRs that we have purchased from third parties. We do not originate residential loans and we believe the initial 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. However, in some cases, for example, where loans were acquired from companies that have since become insolvent, repurchase claims may result in our being liable for a repurchase obligation.

At June 30, 2015 and December 31, 2014, our repurchase reserve associated with our residential loans and MSRs was $5 million and $4 million, respectively, and was recorded in accrued expenses and other liabilities on our consolidated balance sheets. We received 50 repurchase requests during the six months ended June 30, 2015 and none during the six months ended June 30, 2014. We repurchased one loan during the six months ended June 30, 2015. The loan was repurchased from us by the loan originator, resulting in no loss to us. During the six months ended June 30, 2015 and 2014 we recorded repurchase provisions of $1 million and less than $1 million, respectively, that were recorded in mortgage banking and investment activities, net and MSR income (loss), net on our consolidated statements of income and did not charge-off any amounts to the reserve in either period.

Loss Contingencies — Litigation

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the “FHLB-Seattle”) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (“SRF”), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the “FHLB-Seattle Defendants”) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Seattle Certificate”) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the “2005-4 RMBS”) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys’ fees and costs. The Seattle Certificate was issued with an original principal amount of approximately $133 million, and, as of June 30, 2015, the FHLB-Seattle has received approximately $119 million of principal and $11 million of interest payments in respect of the Seattle Certificate. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle's claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation ("Schwab") filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the "Schwab Defendants") alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. Schwab alleged only a claim for negligent misrepresentation under California state law against SRF and sought unspecified damages and attorneys' fees and costs from SRF. Schwab claims that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the "Schwab Certificate") issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. On November 14, 2014, Schwab voluntarily dismissed with prejudice its negligent misrepresentation claim, which resulted in the dismissal with prejudice of SRF from the action. The Schwab Certificate was issued with an original principal amount of approximately $15 million, and, as of June 30, 2015, approximately $13 million of principal and $1 million of interest payments have been made in respect of the Schwab Certificate. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named and remain as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At June 30, 2015, the aggregate amount of loss contingency reserves established in respect of the FHLB-Seattle and Schwab litigation matters described above was $2 million. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

In the ordinary course of any litigation matter, including certain of the above-referenced matters, we have engaged and may continue to engage in formal or informal settlement communications with the plaintiffs. Settlement communications we have engaged in relating to certain of the above-referenced litigation matters are one of the factors that have resulted in our determination to establish the loss contingency reserves described above. We cannot be certain that any of these matters will be resolved through a settlement prior to trial and we cannot be certain that the resolution of these matters, whether through trial or settlement, will not have a material adverse effect on our financial condition or results of operations in any future period.

Future developments (including resolution of substantive pre-trial motions relating to these matters, receipt of additional information and documents relating to these matters (such as through pre-trial discovery), new or additional settlement communications with plaintiffs relating to these matters, or resolutions of similar claims against other defendants in these matters) could result in our concluding in the future to establish additional loss contingency reserves or to disclose an estimate of reasonably possible losses in excess of our established reserves with respect to these matters. Our actual losses with respect to the above-referenced litigation matters may be materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters, including in the event that any of these matters proceeds to trial and the plaintiff prevails. Other factors that could result in our concluding to establish additional loss contingency reserves or estimate additional reasonably possible losses, or could result in our actual losses with respect to the above-referenced litigation matters being materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters include that: there are significant factual and legal issues to be resolved; information obtained or rulings made during the lawsuits could affect the methodology for calculation of the available remedies; and we may have additional obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters that could increase our potential losses.

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Note 16. Equity

The following table provides a summary of changes to accumulated other comprehensive income by component for the three and six months ended June 30, 2015 and 2014.

Changes in Accumulated Other Comprehensive Income by Component

	Three Months Ended June 30, 2015		Three Months Ended June 30, 2014	
(In Thousands)	Net unrealized gains on available-for-sale securities	Net unrealized losses on interest rate agreements accounted for as cash flow hedges	Net unrealized gains on available-for-sale securities	Net unrealized losses on interest rate agreements accounted for as cash flow hedges
Balance at beginning of period	$190,100	$(54,460)	$185,275	$(24,623)
Other comprehensive income (loss) before reclassifications	(5,080)	15,469	12,721	(5,401)
Amounts reclassified from other accumulated comprehensive income	(5,361)	26	(454)	39
Net current-period other comprehensive income (loss)	(10,441)	15,495	12,267	(5,362)
Balance at End of Period	$179,659	$(38,965)	$197,542	$(29,985)

	Six Months Ended June 30, 2015		Six Months Ended June 30, 2014	
(In Thousands)	Net unrealized gains on available-for-sale securities	Net unrealized losses on interest rate agreements accounted for as cash flow hedges	Net unrealized gains on available-for-sale securities	Net unrealized losses on interest rate agreements accounted for as cash flow hedges
Balance at beginning of period	$186,737	$(46,049)	$164,654	$(15,888)
Other comprehensive income (loss) before reclassifications	(28)	7,026	33,229	(14,196)
Amounts reclassified from other accumulated comprehensive income	(7,050)	58	(341)	99
Net current-period other comprehensive income (loss)	(7,078)	7,084	32,888	(14,097)
Balance at End of Period	$179,659	$(38,965)	$197,542	$(29,985)

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Note 16. Equity - (continued)

The following table provides a summary of reclassifications out of accumulated other comprehensive income for three and six months ended June 30, 2015 and 2014.

Reclassifications Out of Accumulated Other Comprehensive Income

(In Thousands)	Affected Line Item in the Income Statement	Amount Reclassified From Accumulated Other Comprehensive Income Three Months Ended June 30, 2015	2014
Net realized gains (losses) on AFS securities			
Other than temporary impairment	Mortgage banking and investment activities, net	$—	$264
Gain on sale of AFS securities	Realized gains, net	(5,361)	(718)
		$(5,361)	$(454)
Net realized gains on interest rate agreements designated as cash flow hedges			
Amortization of deferred loss	Interest expense	$26	$39
		$26	$39

(In Thousands)	Affected Line Item in the Income Statement	Amount Reclassified From Accumulated Other Comprehensive Income Six Months Ended June 30, 2015	2014
Net realized gains (losses) on AFS securities			
Other than temporary impairment	Mortgage banking and investment activities, net	$—	$377
Gain on sale of AFS securities	Realized gains, net	(7,050)	(718)
		$(7,050)	$(341)
Net realized gains on interest rate agreements designated as cash flow hedges			
Amortization of deferred loss	Interest expense	$58	$99
		$58	$99

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Note 16. Equity - (continued)

Earnings Per Common Share
The following table provides the basic and diluted earnings per common share computations for the three and six months ended June 30, 2015 and 2014.
Basic and Diluted Earnings Per Common Share

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands, Except Share Data)	2015	2014	2015	2014
Basic Earnings Per Common Share:				
Net income attributable to Redwood	$27,064	$16,017	$41,865	$28,350
Less: Dividends and undistributed earnings allocated to participating securities	(642)	(537)	(1,375)	(1,239)
Net income allocated to common shareholders	$26,422	$15,480	$40,490	$27,111
Basic weighted average common shares outstanding	83,936,844	82,740,012	83,650,170	82,575,636
Basic Earnings Per Common Share	$0.31	$0.19	$0.48	$0.33
Diluted Earnings Per Common Share:				
Net income attributable to Redwood	$27,064	$16,017	$41,865	$28,350
Less: Dividends and undistributed earnings allocated to participating securities	(619)	(537)	(1,375)	(1,239)
Add back: Interest expense on convertible notes for the period, net of tax	2,789	—	—	—
Net income allocated to common shareholders	$29,234	$15,480	$40,490	$27,111
Weighted average common shares outstanding	83,936,844	82,740,012	83,650,170	82,575,636
Net effect of dilutive equity awards	1,546,038	2,292,986	1,823,735	2,418,685
Net effect of assumed convertible notes conversion to common shares	9,466,859	—	—	—
Diluted weighted average common shares outstanding	94,949,741	85,032,998	85,473,905	84,994,321
Diluted Earnings Per Common Share	$0.31	$0.18	$0.47	$0.32

For the three and six months ended June 30, 2015 and 2014, we determined certain equity awards outstanding during each of these periods qualified as participating securities. We included participating securities in the calculation of basic earnings per common share as well as diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method for these shares. For the three and six months ended June 30, 2015, there were 1,546,038 and 1,823,735 of dilutive equity awards, respectively. For the three and six months ended June 30, 2014, there were 2,292,986 and 2,418,685 of dilutive equity awards, respectively. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances. For the three months ended June 30, 2015, common shares related to the assumed conversion of convertible notes totaling 9,466,859 were included in the calculation of diluted earnings per share as they were determined to be dilutive.
For the three and six months ended June 30, 2015, 11,825,450 and 21,292,309, respectively, of common shares related to the assumed conversion of the convertible notes were antidilutive and were excluded in the calculation of diluted earnings per share. For the three and six months ended June 30, 2015, the number of outstanding equity awards that were antidilutive totaled 286,075 and 299,491, respectively. For the three and six months ended June 30, 2014, the number of outstanding equity awards that were antidilutive totaled 70,508 and 271,392, respectively.

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Note 16. Equity - (continued)

Stock Repurchases
We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and had no expiration date. During the six months ended June 30, 2015, there were no shares acquired under the plan.
In August 2015, our Board of Directors authorized the repurchase of up to $100 million of our common stock, replacing the Board's previous share repurchase authorization. Our share repurchase authorization does not obligate us to acquire any specific number of shares. Under this authorization, shares may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. As of August 7, 2015, no shares had been acquired under this authorization.

Note 17. Equity Compensation Plans
At June 30, 2015 and December 31, 2014, 1,987,975 and 2,225,245 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled $22 million at June 30, 2015, as shown in the following table.

	Six Months Ended June 30, 2015				
(In Thousands)	Restricted Stock	Deferred Stock Units	Performance Stock Units	Employee Stock Purchase Plan	Total
Unrecognized compensation cost at beginning of period	$1,091	$12,304	$6,874	$—	$20,269
Equity grants	2,709	5,923	—	236	8,868
Equity grant forfeitures	(387)	—	—	—	(387)
Equity compensation expense	(521)	(3,931)	(1,709)	(116)	(6,277)
Unrecognized Compensation Cost at End of Period	$2,892	$14,296	$5,165	$120	$22,473

At June 30, 2015, the weighted average amortization period remaining for all of our equity awards was less than two years.
Restricted Stock
At June 30, 2015 and December 31, 2014, there were 187,669 and 109,464 shares, respectively, of restricted stock awards outstanding. Restrictions on these shares lapse through 2019. During the six months ended June 30, 2015, there were 139,526 restricted stock awards granted, 40,643 restricted stock awards that vested and were distributed, and 20,678 restricted stock awards forfeited.
Deferred Stock Units ("DSUs")
At June 30, 2015 and December 31, 2014, there were 2,169,028 and 2,168,824 DSUs, respectively, outstanding of which 1,235,082 and 1,287,862, respectively, had vested. There were 314,527 DSUs granted, and 314,323 DSUs distributed, and no DSUs forfeited during the six months ended June 30, 2015. Unvested DSUs at June 30, 2015 vest through 2019.
Performance Stock Units ("PSUs")
At both June 30, 2015 and December 31, 2014, the target number of PSUs that were unvested was 761,051. PSUs do not vest until the third anniversary of their grant date, with the level of vesting at that time contingent on total stockholder return (defined as the change in our common stock price plus dividends paid on our common stock relative to the per share price of our common stock on the date of the PSU grant) over the three-year vesting period

(“Three-Year TSR”). The number of underlying shares of our common stock that will vest during 2015 and in future years will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the target number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period.

With respect to the PSUs granted in 2011, the three-year performance period ended during the fourth quarter of 2014, resulting in the vesting of 701,440 shares of our underlying common stock. The distribution of these underlying shares of common stock occurred in May 2015, in accordance with the terms of the PSUs and our Executive Deferred Compensation Plan.

Employee Stock Purchase Plan

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. As of June 30, 2015 and December 31, 2014, 292,145 and 274,318 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP at June 30, 2015.

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Note 18. Mortgage Banking and Investment Activities, Net

The following table presents the components of mortgage banking and investment activities, net, recorded in our consolidated statements of income for the three and six months ended June 30, 2015 and 2014.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Residential mortgage banking activities, net:				
Changes in fair value of:				
Residential loans, at fair value (1)	$(2,122)	$17,575	$18,192	$24,709
Real estate securities (2)	—	(8,810)	(14,359)	(13,087)
Risk management derivatives (3)	2,752	(7,858)	(1,619)	(12,136)
Hedging allocation (2)	2,803	—	2,803	—
Other income, net (4)	1,400	435	2,035	790
Total residential mortgage banking activities, net:	4,833	1,342	7,052	276
Commercial mortgage banking activities, net:				
Changes in fair value of:				
Commercial loans, at fair value	987	5,714	6,844	9,340
Risk management derivatives (3)	1,463	(816)	(4,750)	(3,619)
Other fee income	164	83	227	93
Total commercial mortgage banking activities, net:	2,614	4,981	2,321	5,814
Investment activities, net				
Changes in fair value of:				
Residential loans held-for-investment, at Redwood	(5,885)	—	(3,907)	—
Real estate securities	6,927	(186)	7,197	(453)
Net investments in consolidated Sequoia entities	(684)	(321)	(1,777)	(464)
Risk sharing investments	228	—	(702)	—
Risk management derivatives	429	(3,627)	(944)	(9,354)
Hedging allocation (2)	(2,803)	—	(2,803)	—
Total investment activities:	(1,788)	(4,134)	(2,936)	(10,271)
Mortgage banking and investment activities, net	$5,659	$2,189	$6,437	$(4,181)

(1) Includes changes in fair value for associated loan purchase and forward sale commitments.

(2) In the second quarter of 2015, we transferred securities previously utilized as hedges for our mortgage banking segment to our residential investments segment and began to record a hedging allocation between our business segments. See Note 21 for further discussion.

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

(4) Amounts in this line item include other fee income from loan acquisitions and the provision for repurchases expense, presented net.

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Note 19. Operating Expenses
Components of our operating expenses for the three and six months ended June 30, 2015 and 2014 are presented in the following table.
Operating Expenses

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2015	2014	2015	2014
Fixed compensation expense	$9,286	$6,872	$18,441	$13,664
Variable compensation expense	3,578	3,243	7,569	5,974
Equity compensation expense	3,539	2,824	6,277	5,154
Total compensation expense	16,403	12,939	32,287	24,792
Systems and consulting	2,242	3,977	4,364	7,443
Accounting and legal	1,130	1,183	2,707	2,816
Office costs	1,366	1,170	2,598	2,155
Corporate costs	512	558	1,037	1,111
Other operating expenses	3,565	2,455	7,288	3,937
Total Operating Expenses	$25,218	$22,282	$50,281	$42,254

Note 20. Taxes
For the six months ended June 30, 2015 and 2014, we recognized a benefit for income taxes of $3 million and $2 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at June 30, 2015 and 2014.
Reconciliation of Statutory Tax Rate to Effective Tax Rate

	June 30, 2015		June 30, 2014	
Federal statutory rate	34.0	%	34.0	%
State statutory rate, net of Federal tax effect	7.2	%	7.2	%
Differences in taxable (loss) income from GAAP income	(15.6	)%	(2.5	)%
Change in valuation allowance	1.6	%	1.2	%
Dividends paid deduction	(34.6	)%	(45.5	)%
Effective Tax Rate	(7.4	)%	(5.6	)%

The negative effective tax rate for the six months ended June 30, 2015 and 2014, resulted from a benefit for income taxes being recorded against GAAP losses generated at our taxable REIT subsidiaries, while the consolidated income statement reported GAAP income. On a consolidated basis, GAAP income generated at the REIT, for which no material tax provision was recorded, due to the dividends paid deduction, exceeded the losses at the taxable REIT subsidiaries.
We assessed our tax positions for all open tax years (Federal - years 2011 to 2015, State - years 2010- 2015) and, at June 30, 2015 and December 31, 2014, concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

Note 21. Segment Information

Redwood operates in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For a full description of our segments, see Item 1—Business in our Annual Report on Form 10-K.

Segment contribution represents the measure of profit that management uses to assess the performance of our business segments and make resource allocation and operating decisions. Certain expenses not directly assigned or allocated to one of the three primary segments, as well as activity from certain consolidated Sequoia entities consolidated for GAAP financial reporting purposes, are included in the Corporate/Other column as reconciling items to our consolidated financial statements. These unallocated expenses primarily include interest expense associated with certain long-term debt, indirect operating expenses, and other expense.

Prior to the second quarter of 2015, we utilized certain Sequoia interest only (IO) securities in part to serve as hedges in our residential mortgage banking segment. As such, we included these securities in the segment's assets as well as the interest income and valuation adjustments related to the securities in the segment's results. During the second quarter of 2015, we transferred these securities to our residential investments segment.

Additionally, beginning in the second quarter of 2015, we began to record a hedging allocation between our segments. As we currently manage our market interest rate risk on an enterprise-wide basis, we rely on certain assets to serve as natural hedges to other assets, and in some cases these assets can be in different segments. Management uses this allocation to assess the economic returns of each segment on a stand-alone basis and the allocation has no impact on our consolidated results.

This is a prospective change in how we are managing our business and allocating capital to each segment. As such, we have not conformed prior year results for our segments. Analysis of our year-over-year results are discussed in Part I, Item 2, Management's Discussion and Analysis of Results of Operations in this quarterly report on Form 10-Q.

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Note 21. Segment Information - (continued)

The following tables present financial information by segment for the three and six months ended June 30, 2015 and 2014.

Business Segment Financial Information

	Three Months Ended June 30, 2015				
(In Thousands)	Residential Mortgage Banking	Residential Investments	Commercial Mortgage Banking and Investments	Corporate/ Other	Total
Interest income	$9,976	$34,249	$12,679	$6,469	$63,373
Interest expense	(3,298)	(2,660)	(3,497)	(13,553)	(23,008)
Net interest income (loss)	6,678	31,589	9,182	(7,084)	40,365
Reversal of provision for loan losses	—	—	261	—	261
Non-interest income					
Mortgage banking and investment activities, net [1]	4,833	(1,104)	2,614	(684)	5,659
MSR income (loss), net	—	830	—	—	830
Other income	—	1,299	—	—	1,299
Realized gains, net	—	6,316	—	—	6,316
Total non-interest income, net	4,833	7,341	2,614	(684)	14,104
Direct operating expenses	(11,033)	(1,171)	(3,020)	(9,994)	(25,218)
(Provision for) benefit from income taxes	865	(3,768)	(143)	598	(2,448)
Segment Contribution	$1,343	$33,991	$8,894	$(17,164)	
Net Income					$27,064
Non-cash amortization income (expense)	(44)	9,324	(78)	(995)	8,207
Hedging allocations [1]	2,803	(2,753)	—		