REDWOOD TRUST INC
Form 10-Q
August 04, 2011

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, 2011

OR

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

For the Transition Period from to .

Commission File Number 1-13759

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	68-0329422 (I.R.S. Employer Identification No.)
One Belvedere Place, Suite 300 Mill Valley, California (Address of Principal Executive Offices)	94941 (Zip Code)

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 o

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	78,706,126 shares outstanding as of August 3, 2011

REDWOOD TRUST, INC.
2011 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data) (Unaudited)	June 30, 2011	December 31, 2010
ASSETS		
Residential real estate loans	$3,860,233	$3,797,095
Commercial real estate loans	83,866	50,386
Real estate securities, at fair value:		
Trading securities	296,978	329,717
Available-for-sale securities	740,623	825,119
Total real estate securities	1,037,601	1,154,836
Other investments		
Cash and cash equivalents	79,977	46,937
Total earning assets	5,061,677	5,049,254
Restricted cash	35,673	24,524
Accrued interest receivable	13,690	13,782
Derivative assets	4,013	8,051
Deferred tax asset		3,487
Deferred securities issuance costs	6,472	5,928
Other assets	43,463	38,662
Total Assets(1)	$5,164,988	$5,143,688
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$40,891	$44,137
Accrued interest payable	6,422	5,930
Derivative liabilities	82,639	83,115
Accrued expenses and other liabilities	9,954	14,305
Dividends payable	19,640	19,531
Asset-backed securities issued Sequoia	3,566,001	3,458,501
Asset-backed securities issued Acacia	273,325	303,077
Long-term debt	139,500	139,500
Total liabilities(2)	4,138,372	4,068,096
Equity		
Common stock, par value $0.01 per share, 125,000,000 shares authorized; 78,554,965 and 78,124,668 issued and outstanding	786	781
Additional paid-in capital	1,694,077	1,689,851
Accumulated other comprehensive income	80,621	112,339
Cumulative earnings	502,544	474,940
Cumulative distributions to stockholders	(1,253,518)	(1,213,158)

Total stockholders equity	1,024,510	1,064,753
Noncontrolling interest	2,106	10,839
Total equity	1,026,616	1,075,592
Total Liabilities and Equity	$5,164,988	$5,143,688

(1) Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs. At June 30, 2011 and December 31, 2010, these assets totaled $4,005,933 and $3,941,212, respectively.

(2) Our consolidated balance sheets include liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At June 30, 2011 and December 31, 2010, these liabilities totaled $3,912,958 and $3,838,386, respectively.

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)	2011	2010	2011	2010
Interest Income				
Residential real estate loans	$18,904	$15,746	$37,372	$30,235
Commercial real estate loans	1,800	269	3,025	573
Real estate securities	32,234	40,458	66,859	84,357
Other investments		4		13
Cash and cash equivalents	17	93	32	110
Total interest income	52,955	56,570	107,288	115,288
Interest Expense				
Short-term debt	(7)	(36)	(189)	(36)
Asset-backed securities issued	(21,251)	(18,988)	(40,675)	(36,054)
Long-term debt	(2,375)	(2,140)	(4,742)	(3,256)
Total interest expense	(23,633)	(21,164)	(45,606)	(39,346)
Net Interest Income	29,322	35,406	61,682	75,942
Provision for loan losses	(1,581)	(4,321)	(4,389)	(13,797)
Market valuation adjustments	(9,681)	(2,909)	(12,799)	(12,200)
Other-than-temporary impairments(1)	(1,466)	(4,216)	(4,088)	(6,162)
Market valuation adjustments, net	(11,147)	(7,125)	(16,887)	(18,362)
Net Interest Income After Provision and Market Valuation Adjustments	16,594	23,960	40,406	43,783
Operating expenses	(12,087)	(11,227)	(23,600)	(28,533)
Realized gains on sales and calls, net	5,834	16,080	9,699	60,417
Net income before provision for income taxes	10,341	28,813	26,505	75,667
Provision for income taxes	(14)	(26)	(28)	(52)
Net income	10,327	28,787	26,477	75,615
Less: Net income (loss) attributable to noncontrolling interest	888	186	(1,127)	171
Net Income Attributable to Redwood Trust, Inc.	$9,439	$28,601	$27,604	$75,444
Basic earnings per common share	$0.12	$0.36	$0.34	$0.94
Diluted earnings per common share	$0.11	$0.35	$0.34	$0.94
Regular dividends declared per common share	$0.25	$0.25	$0.50	$0.50
Basic weighted average shares outstanding	78,324,057	77,800,642	78,176,767	77,739,279
Diluted weighted average shares outstanding	79,477,504	78,852,259	79,425,360	78,661,642

(1) For the three months ended June 30, 2011, other-than-temporary impairments were $2,655, of which $1,189 were recognized in Accumulated Other Comprehensive Income. For the three months ended June 30, 2010, other-than-temporary impairments were $7,086, of which $2,870 were recognized in Accumulated Other

Comprehensive Income.

For the six months ended June 30, 2011, other-than-temporary impairments were $5,967, of which $1,879 were recognized in Accumulated Other Comprehensive Income. For the six months ended June 30, 2010, other-than-temporary impairments were $10,701, of which $4,539 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 EQUITY AND COMPREHENSIVE INCOME

For the Six Months Ended June 30, 2011

(In Thousands, Except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Noncontrolling Interest	Total
December 31, 2010	78,124,668	$781	$1,689,851	$112,339	$474,940	$(1,213,158)	$10,839	$1,075,592
Net income (loss)					27,604		(1,127)	26,477
Net unrealized (loss) gain on available-for-sale securities				(34,683)			4,164	(30,519)
Reclassification of other-than-temporary impairments to net income				2,349				2,349
Net unrealized loss on interest rate agreements				(1,528)				(1,528)
Reclassification of unrealized loss on interest rate agreements to net income				2,144				2,144
Total other comprehensive loss				(31,718)				
Total comprehensive loss								(1,077)
Issuance of common stock:								
Dividend reinvestment & stock purchase plans	158,028	2	2,349					2,351
Employee stock purchase and incentive plans	272,269	3	(2,929)					(2,926)
Non-cash equity award compensation			4,806					4,806
Distributions to noncontrolling interest, net							(11,770)	(11,770)
Common dividends declared						(40,360)		(40,360)
June 30, 2011	78,554,965	$786	$1,694,077	$80,621	$502,544	$(1,253,518)	$2,106	$1,026,616

For the Six Months Ended June 30, 2010

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands, Except Share Data) (Unaudited)	Six Months Ended June 30, 2011	2010
Cash Flows From Operating Activities:		
Net income attributable to Redwood Trust, Inc.	$27,604	$75,444
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs, net	(17,462)	(16,409)
Depreciation and amortization of non-financial assets	515	439
Provision for loan losses	4,389	13,797
Non-cash equity award compensation	4,806	8,208
Market valuation adjustments, net	16,887	18,362
Realized gains on sales and calls, net	(9,699)	(60,417)
Net change in:		
Accrued interest receivable	(199)	3,732
Deferred tax asset	3,487	2,358
Other assets	123	(13,079)
Accrued interest payable	6,851	5,602
Accrued expenses and other liabilities	(4,351)	(61,644)
Net cash provided by (used in) operating activities	32,951	(23,607)
Cash Flows From Investing Activities:		
Purchases of real estate loans held-for-investment	(293,445)	(238,076)
Principal payments on real estate loans held-for-investment	181,840	148,647
Proceeds from sales of real estate loans held-for-sale	1,857	
Purchases of available-for-sale securities	(46,498)	(186,057)
Proceeds from sales of available-for-sale securities	72,666	247,528
Principal payments on available-for-sale securities	58,416	71,083
Purchases of real estate securities trading		(17,137)
Proceeds from sales of trading securities	13,035	6,119
Principal payments on trading securities	30,261	31,102
Principal payments on other investments		9,675
Net (increase) decrease in restricted cash	(11,149)	67,492
Net cash provided by investing activities	6,983	140,376
Cash Flows From Financing Activities:		
Net repayments on short-term debt	(3,246)	
Proceeds from issuance of asset-backed securities	281,456	211,178
Repurchase of asset-backed securities		(8,639)
Deferred securities issuance costs	(1,695)	(1,667)
Repayments on asset-backed securities	(214,950)	(200,214)
Net settlements of derivatives	(14,733)	(26,268)
Net proceeds from issuance of common stock	(580)	1,731
Dividends paid	(40,250)	(39,865)

Change in noncontrolling interests	(12,896)	(7,467)
Net cash used in financing activities	(6,894)	(71,211)
Net increase in cash and cash equivalents	33,040	45,558
Cash and cash equivalents at beginning of period	$46,937	$242,818
Cash and cash equivalents at end of period	$79,977	$288,376
Supplemental Disclosures:		
Cash paid for interest	$36,404	$32,646
Cash paid for taxes	$45	$15
Dividends declared but not paid at end of period	$19,640	$19,477
Transfers from real estate loans to real estate owned	$5,966	$8,925

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. We seek to invest in assets that have the potential to generate sufficient long-term cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time. For tax purposes, we are structured as a real estate investment trust (REIT).

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2011 and December 31, 2010, and for the three and six months ended June 30, 2011 and 2010. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States of America as prescribed by the Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) and using the Securities and Exchange Commission s (SEC) instructions to Form 10-Q. All amounts presented herein, except share data, are shown in thousands.

Organization

Our consolidated financial statements include the accounts of Redwood, its direct and indirect wholly-owned subsidiaries, and other entities in which we have a controlling financial interest. All significant intercompany balances and transactions have been eliminated. A number of Redwood s consolidated subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We sponsor two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the consolidated Sequoia securitization entities. Our Acacia program was used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia refer collectively to all the consolidated Acacia securitization entities. We are also the asset manager for and an investor in the Redwood Opportunity Fund LP (the Fund) that we sponsor.

Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. We currently consolidate the assets, liabilities, and noncontrolling interests of the Fund, as well as the assets and liabilities of the Sequoia and the Acacia securitization entities where we maintain a continuing involvement. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not obligations of Redwood, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities.

For financial reporting purposes, the underlying loans and securities owned at Sequoia and Acacia entities are shown on our consolidated balance sheets under real estate loans and real estate securities and 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 by consolidated Sequoia and Acacia entities and interest expense on the ABS issued by these entities. The real estate securities owned at the Fund are shown on our consolidated balance sheets under real estate securities and the portion of the Fund owned by third-parties is shown under noncontrolling interest. In our consolidated statements of income, we record interest income on the securities owned at the Fund. Since the Fund is currently funded with equity, there is no associated interest expense.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 2. Basis of Presentation (continued)

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

Note 3. Summary of Significant Accounting Policies

Use of Estimates

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

Fair Value Measurements

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

Quoted prices for the same or similar securities;
Relevant reports issued by analysts and rating agencies;
The current level of interest rates and any directional movements in relevant indices, such as credit risk indices;
Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;
Indicative prices or yields from broker/dealers; and,
Other relevant observable inputs, including nonperformance risk and liquidity premiums.

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

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

Fair Value Option

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

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

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

Real Estate Loans

Residential and Commercial Real Estate Loans Fair Value

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

Residential and Commercial Real Estate Loans Held-for-Sale

Residential and commercial real estate loans held-for-sale include loans that we are marketing for sale to third-parties. These loans are carried at the lower of their cost or fair value, as measured on an individual basis. If the fair value of a loan held-for-sale is lower than its amortized cost basis, this difference is reported as a negative market valuation adjustment through our consolidated statements of income. Coupon interest for loans held-for-sale is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Gains or losses on the sale of real estate loans are based on the specific identification method.

Residential and Commercial Real Estate Loans Held-for-Investment

Real estate loans held-for-investment include residential real estate loans owned and securitized at Sequoia entities and residential and commercial real estate loans owned at Redwood. These loans are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due or when a loan has been individually impaired, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have become greater than 90 days past due or individually impaired is reserved for in the allowance for loan losses. Loans delinquent more than 90 days or in foreclosure are characterized as seriously delinquent. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is used to reduce the outstanding loan principal balance. When a seriously delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Loans that have been individually impaired are placed back on accrual status once the loan is considered reperforming.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

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

See *Note 6* for further discussion on real estate loans.

Residential Real Estate Loans   Allowance for Loan Losses

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

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

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

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

As part of the loss mitigation efforts undertaken by servicers of residential loans owned by Sequoia securitization entities, a growing number of loan modifications have been completed to help make mortgage loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

amounts owed on a mortgage loan; and, (iv) extension of the contractual maturity of a mortgage loan. We evaluate all loan modifications performed by servicers to determine if they constitute troubled debt restructurings according to GAAP. If a loan is determined to be a troubled debt restructuring (TDR), it is removed from the general loan pools used for calculating allowances for loan losses and assessed for impairment on an individual basis based upon any adverse change in the expected future cash flows resulting from the modification. This difference is recorded to the provision for loan losses in our consolidated statements of income.

When foreclosed property is received in full satisfaction for a defaulted loan, we estimate the specific loan loss, if any, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest and other costs) and charge this specific estimated loss against the allowance for loan losses. Foreclosed property is subsequently recorded as real estate owned (REO), a component of other assets on our consolidated balance sheets. Actual losses incurred on loans liquidated through a short-sale are also charged against the allowance for loan losses.

Repurchase Reserves

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

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

Commercial Real Estate Loans   Allowance for Loan Losses

For commercial real estate loans classified as held-for-investment, we establish and maintain an allowance for loan losses on an individual basis for those loans we have determined to be impaired as of the reporting date. To calculate the allowance for loan losses, we assess each loan for indications of adverse credit conditions such as delinquencies or changes in expected future cash flows. Upon identification of an adverse credit condition, the loans are evaluated for impairment and any resulting impairment is recorded in the provision for loan losses in our consolidated statements of income. We re-evaluate the adequacy of our allowance for loan losses at least quarterly.

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

Real Estate Securities, at Fair Value

Trading Securities

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Available-for-Sale (AFS) Securities

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

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

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

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

Other Investments

Other investments included a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial reporting purposes. At December 31, 2010, the GIC had been drawn down completely to cover credit losses and principal reductions on the referenced securities. We accounted for this investment at its estimated fair value. Changes in fair value were reported through our consolidated statements of income through market valuation adjustments, net. Interest income was reported through our consolidated statements of income through interest income, other investments. This GIC represented a deposit certificate issued by a rated investment bank and serves as collateral to cover realized losses on credit default swaps (CDS) entered into by this same Acacia entity.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less. At June 30, 2011, we did not have any significant concentrations of credit risk arising from cash deposits as all of our cash and cash equivalents were invested in FDIC-insured bank products.

Restricted Cash

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities. Restricted cash may also include cash retained in Acacia or Sequoia securitization entities prior to the payments on or redemptions of outstanding ABS issued, or in the Fund prior to distributions to limited partners. At June 30, 2011, we did not have any significant concentrations of credit risk arising from restricted cash deposits as all of our restricted cash was held in custodial accounts or FDIC-insured bank products.

Accrued Interest Receivable

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

Derivative Financial Instruments

Derivative financial instruments include risk management derivatives namely interest rate agreements and credit derivatives. All derivative financial instruments are recorded at fair value in our consolidated balance sheets. Derivatives with a positive fair value to us are reported as an asset and derivatives with a negative fair value to us are reported as a liability. We classify each of our derivative financial instruments as either (i) a trading instrument (no hedging designation) or (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

Changes in fair value of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income through market valuation adjustments, net. Changes in the fair value of derivatives accounted for as cash flow hedges, to the extent they are effective, are recorded in accumulated other comprehensive income, a component of equity. Interest income or expense and any ineffectiveness associated with these hedging derivatives are recorded as a component of net interest income in our consolidated statements of income. We measure the effective portion of cash flow hedges by comparing the change in fair value of the expected future variable cash flows of the derivative hedging instruments with the change in fair value of the expected future variable cash flows of the hedged liabilities.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Risk Management Derivatives

Risk management derivatives that we currently utilize include interest rate swaps and caps. Interest rate swaps are derivative contracts in which (i) one party exchanges a stream of fixed interest payments for another party s stream of variable interest cash flows; or, (ii) each party exchanges variable interest cash flows that are referenced to different indices. Interest rate caps are derivative contracts in which the buyer receives payments at the end of each period in which the interest rate exceeds an agreed upon strike price. We enter into interest rate swaps and caps primarily to reduce significant changes in our income or equity caused by interest rate volatility. Certain of these interest rate agreements may be designated as cash flow hedges.

Other risk management derivatives we currently utilize include To Be Announced (TBA) contracts and financial futures contracts such as Eurodollar futures and Treasury futures. TBA contracts are forward commitments to purchase agency mortgage-backed securities to be issued in the future. Financial futures are futures contracts on short-term benchmark interest rates. We purchase or sell these hedging instruments to offset to varying degrees changes in the values of mortgage products for which we have exposure.

Credit Derivatives

Credit derivatives that we have historically utilized include CDS, which are agreements to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. These instruments enable us, or our consolidated securitization entities, to synthetically assume the credit risk of a reference security or index of securities. The estimated fair values of these contracts fluctuate for a variety of reasons, such as the likelihood or occurrence of a qualifying credit event (e.g., an interest shortfall, a failure to pay principal, or a distressed rating downgrade), the market perception of default risk and counterparty risk, and supply and demand changes. We do not designate any credit derivatives as cash flow hedges.

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

Deferred Tax Assets

Our deferred tax assets are generated by differences in GAAP and taxable income at our taxable subsidiaries. These differences generally reflect differing accounting treatments for tax and GAAP, such as accounting for discount and premium amortization, credit losses, equity awards, asset impairments, and certain valuation estimates. As a result of these differences, we may recognize taxable income in periods prior to when we recognize income for GAAP. When this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is reduced.

Deferred Securities Issuance Costs

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

Other Assets

Other assets include REO, derivative margin receivables, fixed assets, principal receivable, and other prepaid expenses. REO property acquired through, or in lieu of, loan foreclosure is initially recorded at fair value, and subsequently reported at the lower of carrying amount or fair value (less estimated cost to sell).

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Changes in the fair value of an REO property that has a fair value at or below its carrying amount are recorded in our consolidated statements of income as a component of market valuation adjustments, net. Derivative margin receivables reflect cash collateral Redwood has posted with our various derivative counterparties as required to satisfy the minimum margin requirements.

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

Short-Term Debt

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

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

Accrued Interest Payable

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

Asset-Backed Securities Issued Sequoia and Acacia

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

Sequoia ABS Issued

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

Acacia ABS Issued

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

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

Long-Term Debt

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 3. Summary of Significant Accounting Policies (continued)

Equity

Accumulated Other Comprehensive Income

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

Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership interests in the Fund held by third-parties. In accordance with GAAP, the noncontrolling interest of the Fund is shown as a component of equity on our consolidated balance sheets, and the portion of income allocable to third-parties is shown as net income (loss) attributable to noncontrolling interest in our consolidated statements of income. Equity attributable to noncontrolling interest is disclosed in our consolidated statements of equity and comprehensive income.

Earnings Per Common Share

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

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

See *Note 15* for further discussion on equity.

Incentive Plans

In May 2010, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided for an increase in the number of shares available for distribution under the plan. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock options (ISOs), non-qualifying stock options (NQSOs), performance stock units (PSUs), deferred stock units (DSUs), restricted stock, performance shares, performance units (including cash), stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a three- or four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

The cost of equity awards is determined in accordance with share-based payment accounting guidance and amortized over the vesting term using an accelerated method for equity awards granted prior to December 1, 2008. For equity awards granted after December 1, 2008, the cost of the awards is amortized

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

over the vesting period on a straight-line basis. Timing differences between the accelerated and straight-line methods of amortization were determined to not be material to our financial statements.

Employee Stock Purchase Plan

In May 2009, our stockholders approved an amendment to our 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP) to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in the Company through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter.

Executive Deferred Compensation Plan

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

401(k) Plan

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

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

Taxes

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

See *Note 18* for further discussion on taxes.

Recent Accounting Pronouncements

In April 2011, the FASB issued Accounting Standards Update (ASU) 2011-02, *A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which provides additional guidance to creditors for evaluating troubled debt restructurings. The amendments clarify the guidance in ASC 310-40, *Receivables: Troubled Debt Restructurings by Creditors*, which requires a creditor to classify a restructuring as a TDR if (1) the restructuring includes a concession by the creditor to the borrower and (2) the borrower is experiencing financial difficulties. The amended guidance requires a creditor to consider all

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 3. Summary of Significant Accounting Policies (continued)

aspects of the restructuring to determine whether it has granted a concession, and includes additional guidance to identify concessions, as well as indicators for determining whether the debtor is facing financial difficulties. In addition, ASU 2011-02 ended the public-entity deferral of TDR disclosures in ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.*

We adopted ASU 2011-02 in the second quarter of 2011. At June 30, 2011, the recorded investment in receivables for which the allowance for loan losses was previously measured under a general allowance for loan losses and are now impaired under ASC 310-10-35 was $2.8 million, and the allowance for loan losses associated with those receivable, on a basis of current evaluation of loss, was $0.3 million at June 30, 2011. For additional disclosures related to TDRs, see *Note 7*.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This ASU converges fair value measurement and disclosure guidance in U.S. GAAP with the guidance concurrently issued by the International Accounting Standards Board. While the amendments in ASU 2011-04 do not modify the requirements for when fair value measurements apply, they do generally represent clarifications on how to measure and disclose fair value under ASC 820, Fair Value Measurement. This ASU is effective for interim and annual periods beginning after December 15, 2011 and should be applied prospectively. Early adoption is not permitted. ASU 2011-04 may increase our disclosures related to fair value measurements, but will not have an effect on our consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income: Presentation of Comprehensive Income.* The ASU eliminates the option to present components of other comprehensive income in the statement of stockholders equity and requires entities to present all non-owner changes in stockholders equity either as a single continuous statement of comprehensive income or as two separate but consecutive statements. This ASU is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011. The amendments should be applied retrospectively and early adoption is permitted. Upon adoption of this ASU, our financial statement presentation will change.

Note 4. Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and VIEs for financial reporting purposes. Specifically, GAAP requires us to consider whether securitizations and other transfers of financial assets should be treated as sales or financings, as well as whether any VIEs (e.g., certain legal entities often used in securitization and other structured finance transactions) should be included in our consolidated financial statements.

The tables below present our analysis of VIEs where we maintain an interest, as distinguished by those we have consolidated for financial reporting purposes and those we have not. The principles of consolidation 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 financial statements during subsequent reporting periods.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 4. Principles of Consolidation (continued)

Analysis of Consolidated VIEs

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

Assets and Liabilities of Consolidated VIEs at June 30, 2011

(Dollars in thousands)	Sequoia Entities	Acacia Entities	The Fund	Total
Real estate loans	$ 3,654,932	$ 12,698	$	$ 3,667,630
Real estate securities		276,527		276,527
Other investments				
Other assets	21,991	37,113	5,103	64,207
Total Assets	$ 3,676,923	$ 326,338	$ 5,103	$ 4,008,364
Asset-backed securities	$ 3,566,001	$ 273,325	$	$ 3,839,326
Other liabilities	4,621	68,991	20	73,632
Total Liabilities	$ 3,570,622	$ 342,316	$ 20	$ 3,912,958
Noncontrolling interest	$	$	$ 2,106	$ 2,106
Number of VIEs	38	10	1	49

We consolidate the assets and liabilities of certain Sequoia securitization entities issued prior to 2010, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Had we not been the transferor and depositor of these securitizations, we would likely not have consolidated them as we determined that we are not the primary beneficiary of these entities in accordance with ASC 810-10. In April 2010 and March 2011, we sponsored residential jumbo mortgage securitizations through our Sequoia program of $238 million and $295 million, respectively. We recorded the assets and liabilities of these entities on our consolidated balance sheets, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Additionally, we determined that we are the primary beneficiary of these VIEs as our ongoing loss mitigation and resolution responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of these entities and our significant investment interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

We consolidate the assets and liabilities of the Acacia securitization entities, as we did not meet the sale criteria at the time we transferred financial assets to these entities and we are the primary beneficiary of these VIEs. Our ongoing asset management responsibilities and call options provide us with the power to direct the activities that most significantly impact the economic performance of these individual entities, and our equity investments in each entity provide us with the obligation to absorb losses or the right to receive benefits that are significant.

We consolidate the assets, liabilities, and noncontrolling interests of the Fund, as we determined that we are the primary beneficiary of this VIE. Our ongoing asset management responsibilities provide us with the power to direct the activities that most significantly impact the Fund s economic performance, and our general and limited partnership interests provide us with the obligation to absorb losses or the right to receive benefits that are significant. In the second quarter of 2011, the Fund sold all of its remaining investments. All partners will receive final distributions in the third quarter of 2011, upon which we will proceed with dissolution of the Fund.

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Note 4. Principles of Consolidation (continued)

Analysis of Non-Consolidated 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 Redwood s interest in third-party VIEs at June 30, 2011, grouped by collateral type and ownership interest.

Third-Party VIE Summary

June 30, 2011 (Dollars in Thousands)	Fair Value	Number of VIEs
Real estate securities at Redwood		
Residential		
Senior	$ 593,350	95
Re-REMIC	77,575	7
Subordinate	82,881	186
Commercial	5,865	10
CDO	1,403	9
Total Third-party Real Estate Securities	$ 761,074	307

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

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 measure the fair value of the assets and liabilities. This hierarchy prioritizes relevant market inputs in order to determine an exit price , 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 at the date of measurement. Level 1 inputs are observable inputs that reflect quoted prices (unadjusted) 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 being 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 in which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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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, 2011 and December 31, 2010.

(In Thousands)	June 30, 2011 Carrying Value	June 30, 2011 Fair Value	December 31, 2010 Carrying Value	December 31, 2010 Fair Value
Assets				
Real estate loans (held-for-investment)				
Residential loans securitized	$ 3,654,932	$ 3,262,580	$ 3,542,158	$ 3,114,288
Residential loans unsecuritized	203,465	207,086	253,082	253,052
Commercial loans unsecuritized	71,168	71,200	30,536	30,887
Real estate loans (held-for-sale)	1,836	1,836	1,855	1,855
Commercial real estate loans (fair value)	12,698	12,698	19,850	19,850
Trading securities	296,978	296,978	329,717	329,717
Available-for-sale securities	740,623	740,623	825,119	825,119
Cash and cash equivalents	79,977	79,977	46,937	46,937
Derivative assets	4,013	4,013	8,051	8,051
Restricted cash	35,673	35,673	24,524	24,524
Accrued interest receivable	13,690	13,690	13,782	13,782
REO (included in other assets)	9,880	9,880	14,481	14,481
Liabilities				
Short-term debt	40,891	40,891	44,137	44,137
Accrued interest payable	6,422	6,422	5,930	5,930
Derivative liabilities	82,639	82,639	83,115	83,115
ABS issued				
ABS issued Sequoia	3,566,001	3,085,586	3,458,501	2,959,997
ABS issued Acacia	273,325	273,325	303,077	303,077
Total ABS issued	3,839,326	3,358,911	3,761,578	3,263,074
Long-term debt	139,500	78,120	139,500	75,330

We did not elect the fair value option for any financial instruments that we acquired in the first six months of 2011. We have elected the fair value option for all of the commercial loans, trading securities, and ABS issued at Acacia, as well as certain residential securities and CDOs at Redwood.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents assets and liabilities recorded at fair value on our consolidated balance sheet on a recurring basis and indicates the fair value hierarchy of the valuation techniques used to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2011

June 30, 2011	Carrying	Fair Value Measurements Using		
(In Thousands)	Value	Level 1	Level 2	Level 3
Assets				
Commercial real estate loans	$ 12,698	$	$	$ 12,698
Trading securities	296,978			296,978
Available-for-sale securities	740,623			740,623
Derivative assets	4,013	276	3,737	
Liabilities				
Derivative liabilities	82,639	1,425	81,214	
ABS issued Acacia	273,325			273,325

The following table presents additional information about Level 3 assets and liabilities for the six months ended June 30, 2011.

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

	Assets				Liabilities
(In Thousands)	Commercial Real Estate Loans	Trading Securities	AFS Securities	Derivative Assets	ABS Issued Acacia
Beginning balance December 31, 2010	$19,850	$329,717	$825,119	$ 1	$ 303,077
Principal paydowns	(8,694)	(30,261)	(58,416)		(42,873)
Gains in net income, net	1,542	10,322	19,064		6,757
Losses in OCI, net			(28,170)		
Acquisitions			46,498		

Sales		(13,035)	(63,525)		
Other settlements, net		235	53	(1)	6,364
Ending Balance June 30, 2011	$12,698	$296,978	$740,623	$	$ 273,325

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and still held at June 30, 2011 and 2010. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and six months ended June 30, 2011 and 2010 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2011 and 2010 Included in Net Income

	Included in Net Income			
	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2011	2010	2011	2010
Assets				
Real estate loans	$ 1,323	$ 2,978	$ 1,542	$ 7,344
Trading securities	(9,557)	5,042	1,070	17,364
Available-for-sale securities	(1,466)	(4,216)	(2,469)	(6,134)
Derivative assets		15		(5)
Liabilities				
Derivative liabilities		49		109
ABS issued Acacia	17,380	11,257	(6,757)	6,004

The following table presents information on assets and liabilities recorded at fair value on a non-recurring basis at June 30, 2011.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at June 30, 2011

		Fair Value Measurements Using			Gain (Loss)	
(In Thousands)	Carrying Value	Level 1	Level 2	Level 3	Three Months Ended June 30, 2011	Six Months Ended June 30, 2011

Assets						
Real estate loans (held-for-sale)	$ 1,836	$	$	$ 1,836	$ 8	$ 11
REO	9,880			9,880	(244)	(1,162)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the three and six months ended June 30, 2011 and 2010.

Market Valuation Adjustments, Net

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2011	2010	2011	2010
Assets				
Real estate loans (fair value)	$ 1,323	$ 2,978	$ 1,542	$ 7,344
Real estate loans (held-for-sale)	8	296	11	176
Trading securities	(9,594)	6,330	10,322	18,479
REO	(244)	(1,285)	(1,162)	(1,359)
Impairments on AFS securities	(1,466)	(4,216)	(4,088)	(6,162)
Liabilities				
ABS issued Acacia	17,380	11,257	(6,757)	6,004
Derivative instruments, net	(18,554)	(22,485)	(16,755)	(42,844)
Market Valuation Adjustments, Net	$ (11,147)	$ (7,125)	$ (16,887)	$ (18,362)

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 below.

Real estate loans

Residential real estate loan fair values are determined by available market quotes and discounted cash flow analyses (Level 3).

Commercial real estate loan fair values are determined by available market quotes and discounted cash flow analyses (Level 3). The availability of market quotes for all of our commercial loans is limited. Any changes in fair value are primarily a result of instrument specific credit risk.

Real estate securities

Real estate securities are residential, commercial, CDO, and other asset-backed securities that are illiquid in nature and trade infrequently. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third-party dealer/pricing indications, to the extent available. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. Relevant market indicators that are factored in the analyses include bid/ask spreads, credit losses, interest rates, and prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. For June 30, 2011, we received dealer marks on 83% of our securities. In the aggregate, our internal valuations of the securities on which we received dealer marks were 3% lower (i.e., more conservative) than the aggregate dealer marks.

Derivative assets and liabilities

Our derivative instruments include interest rate agreements, TBAs, and financial futures. Fair values of derivative instruments are determined using quoted prices from active markets when

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

available or valuation models and are verified 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). Valuation models require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of such inputs. Model inputs for interest rate agreements can generally be verified and model selection does not involve significant management judgment (Level 2). For other derivatives, valuations are based on various factors such as liquidity, bid/offer spreads, and credit considerations for which we rely on available market evidence. In the absence of such evidence, management s best estimate is used (Level 3).

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.

Restricted cash

Restricted cash primarily includes interest-earning cash balances in ABS entities and the Fund for the purpose of distribution to bondholders or limited partners, and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values.

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.

Short-term debt

Short-term debt includes our credit facilities that mature within one year. Short-term debt is generally at an adjustable rate. Fair values approximate carrying values.

ABS issued

ABS issued includes asset-backed securities issued through our Sequoia and Acacia programs. These instruments are illiquid in nature and trade infrequently, if at all. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third-party dealer/pricing indications, to the extent available. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Relevant market indicators factored into the analyses include dealer price indications to the extent available, bid/ask spreads, external spreads, collateral credit losses, interest rates and collateral prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. For June 30, 2011, we received dealer marks on 95% of our ABS issued. Our internal valuations of our ABS issued on which we received dealer marks were 7% higher (i.e., more conservative) than the aggregate dealer marks.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Long-term debt

Long-term debt includes our subordinated notes and trust preferred securities. Fair values are determined using comparable market indicators of current pricing. 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).

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).

Note 6. Real Estate Loans

We invest in residential real estate loans that we acquire from third-party originators and commercial loans that we originate or acquire from third-party originators. These loans are financed through the Sequoia and Acacia entities that we sponsor or with equity and long-term debt. We do not currently service any residential loans. Commercial loans originated by our subsidiary, Redwood Commercial Mortgage Corporation, in 2010 and 2011 and held-for-investment are currently serviced by us.

The following table summarizes the classifications and carrying value of the residential and commercial real estate loans recorded on our consolidated balance sheets at June 30, 2011 and December 31, 2010.

June 30, 2011 (In Thousands)	Redwood	Sequoia	Acacia	Total Loans
Residential real estate loans				
Held-for-sale	$ 1,836	$	$	$ 1,836
Held-for-investment	203,465	3,654,932		3,858,397
Total residential real estate loans	205,301	3,654,932		3,860,233
Commercial real estate loans				
Fair value			12,698	12,698
Held-for-investment	71,168			71,168
Total commercial real estate loans	71,168		12,698	83,866
Total Real Estate Loans	$ 276,469	$ 3,654,932	$ 12,698	$ 3,944,099

	Redwood	Sequoia	Acacia

December 31, 2010 (In Thousands)				Total Loans
Residential real estate loans				
Held-for-sale	$ 1,855	$	$	$ 1,855
Held-for-investment	253,081	3,542,159		3,795,240
Total residential real estate loans	254,936	3,542,159		3,797,095
Commercial real estate loans				
Fair value			19,850	19,850
Held-for-investment	30,536			30,536
Total commercial real estate loans	30,536		19,850	50,386
Total Real Estate Loans	$ 285,472	$ 3,542,159	$ 19,850	$ 3,847,481

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 6. Real Estate Loans (continued)

Residential Real Estate Loans Held-for-Sale

Residential real estate loans held-for-sale are owned at Redwood and financed with equity and long-term debt. At both June 30, 2011 and December 31, 2010, there were eleven residential loans held-for-sale with $3 million in outstanding principal value and a lower of cost or fair value of $2 million.

Residential Real Estate Loans Held-for-Investment

During the six months ended June 30, 2011, we purchased $254 million of residential loans in connection with our Sequoia securitization program.

The following table provides additional information on residential real estate loans held-for-investment at June 30, 2011 and December 31, 2010.

(In Thousands)	June 30, 2011	December 31, 2010
Principal value	$ 3,882,603	$ 3,815,273
Unamortized premium, net	38,100	42,399
Recorded investment	3,920,703	3,857,672
Allowance for loan losses	(62,306)	(62,432)
Carrying Value	$ 3,858,397	$ 3,795,240

Of the $3.9 billion of principal value and $38 million of unamortized premium on loans held-for-investment at June 30, 2011, $1.6 billion of principal value and $25 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the first six months of 2011, 4% of these residential loans prepaid and we amortized 9% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal value was $2.3 billion and the unamortized premium was $13 million. During the first six months of 2011, 5% of these loans prepaid and we amortized 7% of the premium.

Of the $3.8 billion of principal value and $42 million of unamortized premium on loans held-for-investment at December 31, 2010, $1.7 billion of principal value and $28 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal value was $2.1 billion and the unamortized premium was $15 million.

Commercial Real Estate Loans at Fair Value

Commercial real estate loans at fair value are owned at the consolidated Acacia securitization entities. At June 30, 2011, there were three commercial real estate loans at fair value with an aggregate outstanding principal value of $14 million and an aggregate fair value of $13 million. At December 31, 2010, there were four commercial real estate loans at fair value with an aggregate outstanding principal value of $23 million and an aggregate fair value of $20 million.

Commercial Real Estate Loans Held-for-Investment

During the three months ended June 30, 2011, we originated or acquired three commercial real estate loans with an outstanding principal balance of $29 million. At June 30, 2011, there were nine commercial real estate loans held-for-investment (one of which was purchased prior to 2010) with an outstanding principal value of $72 million and a carrying value of $71 million. At December 31, 2010, there were four commercial real estate loans held-for-investment with an outstanding principal value and carrying value of $31 million.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 7. Allowance for Loan Losses

Allowance for Loan Losses on Residential Loans

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

Activity in the Allowance for Loan Losses on Residential Loans

The following table summarizes the activity in the allowance for loan losses for the three and six months ended June 30, 2011 and 2010.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2011	2010	2011	2010
Balance at beginning of period	$ 62,922	$ 61,169	$ 62,432	$ 54,220
Charge-offs, net	(2,197)	(4,012)	(4,515)	(6,539)
Provision for loan losses	1,581	4,321	4,389	13,797
Balance at End of Period	$ 62,306	$ 61,478	$ 62,306	$ 61,478

During the three months ended June 30, 2011 and 2010, there were $2 million and $4 million of charge-offs, respectively, in our residential loan portfolio that reduced our allowance for loan losses. These charge-offs arose from $7 million and $13 million of defaulted loan principal, respectively. During the six months ended June 30, 2011 and 2010, there were $5 million and $7 million of charge-offs, respectively, in our residential loan portfolio that reduced our allowance for loan losses. These charge-offs arose from $15 million and $21 million of defaulted loan principal, respectively. As of June 30, 2011 and December 31, 2010, we did not record any interest income on individually impaired loans.

Loans Collectively Evaluated for Impairment

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

The following table summarizes the balances for loans collectively evaluated for impairment at June 30, 2011 and December 31, 2010.

(In Thousands)	June 30, 2011	December 31, 2010
Unpaid principal balance	$ 3,870,056	$ 3,801,921
Recorded investment	3,908,849	3,844,372
Related allowance	58,558	57,804

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 7. Allowance for Loan Losses (continued)

The following table shows the recorded investment in residential loans collectively evaluated for impairment at June 30, 2011 and December 31, 2010.

(In Thousands)	30 59 Days Past Due	60 89 Days Past Due	90+ Days Past Due	Current	Total Loans
June 30, 2011	$ 54,843	$ 20,826	$ 131,991	$ 3,701,189	$ 3,908,849
December 31, 2010	65,708	21,674	133,695	3,623,295	3,844,372

Loans Individually Evaluated for Impairment

The following table summarizes the balances for loans individually evaluated for impairment at June 30, 2011 and December 31, 2010.

(In Thousands)	June 30, 2011	December 31, 2010
Unpaid principal balance	$ 12,547	$ 13,352
Recorded investment	11,854	13,300
Related allowance	3,748	4,628
Average recorded investment for the three months ended	12,199	13,014

The following table shows the recorded investment in residential loans individually evaluated for impairment at June 30, 2011 and December 31, 2010.

(In Thousands)	30 59 Days Past Due	60 89 Days Past Due	90+ Days Past Due	Current	Total Loans
June 30, 2011	$ 1,031	$ 709	$ 804	$ 9,310	$ 11,854
December 31, 2010	2,604		1,046	9,650	13,300

Credit Characteristics of Residential Loans Held-for-Investment

As a percent of total recorded investment, 99% of residential loans held-for-investment on our balance sheet at June 30, 2011, were first lien, predominately prime quality loans, at the time of origination. The remaining 1% of loans at June 30, 2011 were second lien, home equity lines of credit. The weighted average original loan-to-value (LTV) for our residential loans held-for-investment outstanding at June 30, 2011, was 66%. The weighted average Fair Isaac Corporation (FICO) score for the borrowers of these loans (at origination) was 736.

Due to the uniform product and credit characteristics of our residential loans, we consider the year of origination to be a general indicator of credit performance. The following table displays the recorded investment and year of origination for residential loans recorded on our consolidated balance sheets at June 30, 2011 and December 31, 2010.

(In Thousands)	June 30, 2011	December 31, 2010
2003 & Earlier	$ 1,851,493	$ 1,939,618
2004	1,084,285	1,116,358
2005	131,794	136,481
2006	189,212	191,945
2007	68,687	75,136
2008		
2009	169,817	189,355
2010	303,517	208,779
2011	121,898	
Total Recorded Investment	$ 3,920,703	$ 3,857,672

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 7. Allowance for Loan Losses (continued)

Allowance for Loan Losses on Commercial Loans

For commercial real estate loans classified as held-for-investment, we establish and maintain an allowance for loan losses on an individual basis for those loans we have determined to be impaired as of the reporting date. At June 30, 2011 and December 31, 2010, there were no delinquent or impaired commercial loans.

Of the $71 million recorded investment in commercial loans held-for-investment at June 30, 2011, 57% were originated in 2011 and 43% were originated in 2010. Of the $31 million of recorded investment in commercial loans held-for-investment at December 31, 2010, 99% were originated in the fourth quarter of 2010 and 1% were originated in 2004.

Note 8. Real Estate Securities

We invest in third-party residential, commercial, and CDO securities. The following table presents the fair values of our real estate securities by collateral type and entity at June 30, 2011 and December 31, 2010.

June 30, 2011 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	$ 753,806	$	$ 213,755	$ 967,561
Commercial	5,865		42,274	48,139
CDO	1,403		20,498	21,901
Total Real Estate Securities	$ 761,074	$	$ 276,527	$ 1,037,601

December 31, 2010 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	$ 814,683	$ 19,011	$ 248,494	$ 1,082,188
Commercial	7,496		43,828	51,324
CDO	1,038	4,245	16,041	21,324
Total Real Estate Securities	$ 823,217	$ 23,256	$ 308,363	$ 1,154,836

At June 30, 2011, there were $4 million of AFS residential securities that had contractual maturities greater than five years but less than ten years, and the remainder of our real estate securities had contractual maturities greater than ten years.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2011
(Unaudited)

Note 8. Real Estate Securities (continued)

The following table presents our securities by accounting classification, collateral type, and ownership entity at June 30, 2011 and December 31, 2010.

June 30, 2011	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$	$ 3,645	$ 3,645	$ 285,946	$	$ 285,946
Residential non-prime	18,686	104,110	122,796	288,718		288,718
Commercial		11,405	11,405			
Total Senior Securities	18,686	119,160	137,846	574,664		574,664
Re-REMIC Securities				77,575		77,575
Subordinate Securities						
Residential prime	302	40,236	40,538	71,543		71,543
Residential non-prime	160	65,764	65,924	10,876		10,876
Commercial		30,869	30,869	5,865		5,865
CDO	1,303	20,498	21,801	100		100
Total Subordinate Securities	1,765	157,367	159,132	88,384		88,384
Total Real Estate Securities	$ 20,451	$ 276,527	$ 296,978	$ 740,623	$	$ 740,623

December 31, 2010	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$	$ 4,412	$ 4,412	$ 315,891	$	$ 315,891
Residential non-prime	19,742	117,623	137,365	326,365	12,915	339,280
Commercial		11,000	11,000			
Total Senior Securities	19,742	133,035	152,777	642,256	12,915	655,171
Re-REMIC Securities				85,077		85,077
Subordinate Securities						
Residential prime	386	49,620	50,006	53,846		53,846
Residential non-prime	188	76,839	77,027	13,188	6,096	19,284
Commercial		32,828	32,828	7,496		7,496
CDO	1,038	16,041	17,079		4,245	4,245

Total Subordinate Securities	1,612	175,328	176,940	74,530	10,341	84,871
Total Real Estate Securities	$ 21,354	$ 308,363	$ 329,717	$ 801,863	$ 23,256	$ 825,119

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

For purposes of the table above, the prime or non-prime designation used to categorize our residential securities is based upon the general credit characteristics of the residential loans underlying each security at the time of origination. For example, prime residential loans are generally characterized by lower LTV ratios, and are made to borrowers with higher FICO scores. Non-prime residential loans are generally characterized by higher LTV ratios and may have been made to borrowers with lower credit scores or

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 8. Real Estate Securities (continued)

impaired credit histories (while exhibiting the ability to repay their loans). Regardless of whether or not the loans backing a mortgage-backed security were designated as prime or non-prime at origination, there is a risk that the borrower may not be able to repay the loan.

We elected the fair value option for certain securities at Redwood and the Acacia entities, now classified as trading securities. The unpaid principal balance of these trading securities was $1.2 billion and $2.1 billion at June 30, 2011 and December 31, 2010, respectively.

AFS Securities

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

The following table presents the components of carrying value (which equals fair value) of AFS securities at June 30, 2011 and December 31, 2010.

June 30, 2011 (In Thousands)	Residential	Commercial	CDO	Total
Current face	$ 1,111,215	$ 58,128	$ 11,863	$ 1,181,206
Credit reserve	(240,899)	(48,987)	(10,780)	(300,666)
Net unamortized discount	(243,662)	(4,362)	(1,083)	(249,107)
Amortized cost	626,654	4,779		631,433
Gross unrealized gains	121,524	1,928	100	123,552
Gross unrealized losses	(13,520)	(842)		(14,362)
Carrying Value	$ 734,658	$ 5,865	$ 100	$ 740,623

	Residential	Commercial	CDO	Total

December 31, 2010				
(In Thousands)				
Current face	$ 1,257,601	$ 89,103	$ 89,476	$ 1,436,180
Credit reserve	(297,849)	(76,979)	(88,394)	(463,222)
Net unamortized (discount) premium	(291,093)	(5,591)	11,485	(285,199)
Amortized cost	668,659	6,533	12,567	687,759
Gross unrealized gains	153,125	1,604		154,729
Gross unrealized losses	(8,406)	(641)	(8,322)	(17,369)
Carrying Value	$ 813,378	$ 7,496	$ 4,245	$ 825,119

The following table presents the changes for the three and six months ended June 30, 2011, of the unamortized discount and designated credit reserves on AFS securities.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 8. Real Estate Securities (continued)

Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

Three Months Ended June 30, 2011 (In Thousands)	Residential Credit Reserve	Residential Unamortized Discount, Net	Commercial Credit Reserve	Commercial Unamortized Discount, Net	CDO Credit Reserve	CDO Unamortized Premium, Net
Beginning balance March 31, 2011	$280,478	$259,469	$64,717	$4,784	$29,505	$520
Amortization of net (discount) premium		(10,497)		(33)		18
Realized credit losses	(34,091)		(16,655)			
Acquisitions	28	9,112				
Sales, calls, other	(11,543)	(9,324)			(18,751)	571
Impairments	929		536			
Transfers to (release of) credit reserves	5,098	(5,098)	389	(389)	26	(26)
Ending Balance June 30, 2011	$240,899	$243,662	$48,987	$4,362	$10,780	$1,083

Six Months Ended June 30, 2011 (In Thousands)	Residential Credit Reserve	Residential Unamortized Discount, Net	Commercial Credit Reserve	Commercial Unamortized Discount, Net	CDO Credit Reserve	CDO Unamortized Discount, Net
Beginning balance December 31, 2010	$297,849	$291,093	$76,979	$5,591	$88,394	$(11,485)
Amortization of net discount		(22,464)		(69)		(85)
Realized credit losses	(56,265)		(25,952)		(3,005)	
Acquisitions	1,176	11,601				
Sales, calls, other	(20,188)	(20,877)	(2,653)	(1,439)	(74,662)	12,146
Impairments	2,636		892		560	
Transfers to (release of) credit reserves	15,691	(15,691)	(279)	279	(507)	507

Ending Balance	June 30, 2011	$240,899	$243,662	$48,987	$4,362	$10,780	$1,083

The loans underlying our residential subordinate securities totaled $31 billion at June 30, 2011. These loans are located nationwide with a large concentration in California (44%). Serious delinquencies (90+ days, in foreclosure or REO) at June 30, 2011 were 5.65% of current principal balances. The loans underlying our commercial subordinate securities totaled $19 billion at June 30, 2011, and consist primarily of office (31%), retail (34%), and multifamily (12%) loans. These loans are located nationwide with the highest concentration in California (15%). Serious delinquencies (60+ days, in foreclosure or REO) at June 30, 2011 were 6.0% of current principal balances.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 8. Real Estate Securities (continued)

AFS Securities with Unrealized Losses

The following table presents the components comprising the carrying value of AFS securities that were in an unrealized loss position at June 30, 2011 and December, 31 2010.

June 30, 2011 (In Thousands)	Less Than 12 Consecutive Months Total Amortized Cost	Gross Unrealized Losses	Total Fair Value	12 Consecutive Months or Longer Total Amortized Cost	Gross Unrealized Losses	Total Fair Value
Residential	$ 133,317	$ (4,100)	$ 129,217	$ 61,687	$ (9,420)	$ 52,267
Commercial	267	(79)	188	2,226	(763)	1,463
CDO						
Total Securities	$ 133,584	$ (4,179)	$ 129,405	$ 63,913	$ (10,183)	$ 53,730

December 31, 2010 (In Thousands)	Less Than 12 Consecutive Months Total Amortized Cost	Gross Unrealized Losses	Total Fair Value	12 Consecutive Months or Longer Total Amortized Cost	Gross Unrealized Losses	Total Fair Value
Residential	$ 104,154	$ (1,628)	$ 102,526	$ 26,374	$ (6,778)	$ 19,596
Commercial	2,134	(257)	1,877	1,728	(384)	1,344
CDO				12,567	(8,322)	4,245
Total Securities	$ 106,288	$ (1,885)	$ 104,403	$ 40,669	$ (15,484)	$ 25,185

At June 30, 2011, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 449 AFS securities, of which 89 were in an unrealized loss position and 28 were in a continuous unrealized loss position for twelve consecutive months or longer. At December 31, 2010, our consolidated balance sheet included 509 AFS securities, of which 80 were in a continuous unrealized loss position, of which 46 were in a continuous unrealized loss position for twelve consecutive months or longer.

Of the total unrealized losses at June 30, 2011, none related to securities owned at the Fund. At December 31, 2010, $10 million of unrealized losses related to securities owned at the Fund and the remaining unrealized losses related to securities owned at Redwood.

Evaluating AFS Securities for Other-than-Temporary Impairments

When the fair value of an AFS security is below its cost basis, we evaluate the security for OTTI. Part of this evaluation is based upon adverse changes in the assumptions used to value the security. The table below summarizes the significant valuation assumptions we used for our AFS securities at June 30, 2011.

Significant Valuation Assumptions

	Range for Securities		
June 30, 2011	Prime	Non-prime	Commercial
Prepayment rates	4 15%	1 8%	N/A
Loss severity	14 57%	22 57%	33 50%
Projected losses	0 26%	1 39%	2 7%

The credit component of OTTI is recognized through our consolidated statement of income as a component of market valuation adjustments, net, while the non-credit component of OTTI is to accumulated other comprehensive income, a component of equity. Total credit OTTI for the three and six months ended June 30, 2011 was $1 million and $4 million, respectively. Total non-credit OTTI for the three and six months

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2011
(Unaudited)

Note 8. Real Estate Securities (continued)

ended June 30, 2011 was $1 million and $2 million, respectively. The following table details the activity related to the credit component of OTTI (i.e., OTTI in either current earnings or retained earnings) for AFS securities that also had a non-credit component and were still held at June 30, 2011 and 2010.

Activity of Credit Component of Other-than-Temporary Impairments

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2011	2010	2011	2010
Balance at beginning of period	$ 100,948	$ 143,116	$ 121,016	$ 146,454
Additions				
Initial credit impairments	449	213	463	303
Subsequent credit impairments	754	3,143	935	4,439
Reductions				
Securities sold, or intent to sell		(5,113)	(12,317)	(5,113)
Securities matured, called, or fully written down	(12,132)	(9,329)	(20,078)	(14,053)
Balance at End of Period	$ 90,019	$ 132,030	$ 90,019	$ 132,030

The credit component is reduced if we sell, intend to sell, or believe we will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if we receive or expect to receive cash flows in excess of what we previously expected to receive over the remaining life of the credit-impaired debt security, the security matures, or is fully written down.

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains on sales and calls, net, in our consolidated statements of income. The following table presents the gross realized gains on sales and calls of AFS securities for the three and six months ended June 30, 2011 and 2010.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2011	2010	2011	2010
Gross realized gains sales	$ 5,351	$ 17,670	$ 12,665	$ 56,524

Gross realized gains calls	401		533	
Gross realized losses sales	(165)	(1,859)	(3,523)	(3,335)
Gross realized losses calls			(223)	
Total Realized Gains on Sales and Calls of AFS Securities, net	$5,587	$15,811	$9,452	$53,189

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2011
(Unaudited)

Note 9. Derivative Financial Instruments

The following table presents the aggregate fair value and notional amount of derivative financial instruments held by Redwood and the consolidated Acacia entities at June 30, 2011 and December 31, 2010. The derivatives held at Acacia entities are not assets or obligations of Redwood.

June 30, 2011 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Assets Risk Management Derivatives						
Interest rate swaps	$	$	$806	$5,796	$806	$5,796
TBAs	274	69,000			274	69,000
Futures	2	44,000			2	44,000
Interest rate caps purchased			2,931	705,400	2,931	705,400
Total Assets	276	113,000	3,737	711,196	4,013	824,196
Liabilities Cash Flow Hedges						
Interest rate swaps	(13,823)	165,000			(13,823)	165,000
Liabilities Risk Management Derivatives						
Interest rate swaps	(1,624)	89,500	(65,766)	612,746	(67,390)	702,246
TBAs	(1,036)	56,000			(1,036)	56,000
Futures	(390)	568,000			(390)	568,000
Total Liabilities	(16,873)	878,500	(65,766)	612,746	(82,639)	1,491,246
Total Derivative Financial Instruments, Net	$(16,597)	$991,500	$(62,029)	$1,323,942	$(78,626)	$2,315,442

December 31, 2010 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Assets Risk Management Derivatives						
Interest rate swaps	$175	$44,000	$813	$18,037	$988	$62,037
TBAs	348	35,000			348	35,000

Futures	703	433,000			703	433,000
Interest rate caps purchased			6,012	703,400	6,012	703,400
Total Assets	1,226	512,000	6,825	721,437	8,051	1,233,437
Liabilities Cash Flow Hedges						
Interest rate swaps	(11,449)	155,500			(11,449)	155,500
Liabilities Risk Management Derivatives						
Interest rate swaps	(1,283)	26,000	(69,373)	663,604	(70,656)	689,604
TBAs	(951)	124,000			(951)	124,000
Futures	(59)	225,000			(59)	225,000
Total Liabilities	(13,742)	530,500	(69,373)	663,604	(83,115)	1,194,104
Total Derivative Financial Instruments, Net	$(12,516)	$1,042,500	$(62,548)	$1,385,041	$(75,064)	$2,427,541

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 9. Derivative Financial Instruments (continued)

Risk Management Derivatives

To offset to varying degrees the changes in the value of mortgage products to which we have exposure, we may enter into interest rate agreements, TBA contracts, and Eurodollar futures contracts. (Eurodollar futures contracts, unlike our other derivatives, have maturities of only three months. Therefore, in order to achieve the desired interest rate offset necessary to manage our risk, consecutively maturing contracts are required resulting in a stated notional amount higher than would be needed with our other derivatives.) We account for our risk management derivatives as trading instruments, and record any changes in value (including any associated interest income or expense) in our consolidated statements of income through market valuation adjustments, net.

Risks Related to Unsecuritized Residential and Commercial Loans at Redwood

In order to manage risks associated with residential loans we own or plan to acquire and securitize, and commercial loans we invest in, at June 30, 2011, we were party to interest rate agreements with an aggregate notional amount of $89 million, TBA contracts sold with a notional amount of $125 million, and financial futures with an aggregate notional amount of $612 million. Net negative market valuation adjustments on these derivatives were $5 million and $2 million for the three and six months ended June 30, 2011, respectively.

Risks Related to Liabilities at Acacia Entities

Net valuation adjustments on interest rate agreements at Acacia were negative $13 million and negative $21 million for the three months ended June 30, 2011 and 2010, respectively. Net valuation adjustments on interest rate agreements at Acacia were negative $14 million and negative $41 million for the six months ended June 30, 2011 and 2010, respectively.

Derivatives Designated as Cash Flow Hedges

To hedge the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated interest rate swaps as cash flow hedges during 2010 and during the second quarter of 2011 with an aggregate notional balance of $165 million. For the three and six months ended June 30, 2011, these hedges decreased in value by $5 million and $2 million, respectively, which was recorded as a decrease to accumulated other comprehensive income, a component of equity.

For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was $29 million at both June 30, 2011 and December 31, 2010. For both the three months ended June 30, 2011 and 2010 we reclassified $1 million of unrealized losses on derivatives to interest expense. For both the six months ended June 30, 2011 and 2010, we reclassified $2 million of unrealized losses on derivatives to interest expense.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 9. Derivative Financial Instruments (continued)

The following table illustrates the impact on interest income (expense) of our interest rate agreements accounted for as cash flow hedges for the three and six months ended June 30, 2011 and 2010.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2011	2010	2011	2010
Net interest expense on cash flow interest rate agreements	$(1,628)	$(1,036)	$(3,166)	$(1,036)
Realized net expense due to net ineffective portion of hedges	(12)	(26)	(13)	(26)
Realized net losses reclassified from other comprehensive income	(1,080)	(1,051)	(2,144)	(1,546)
Total Interest Expense	$(2,720)	$(2,113)	$(5,323)	$(2,608)

Credit Derivatives

At June 30, 2011 and December 31, 2010, we had no outstanding CDS contracts or obligations. During the six months ended June 30, 2010, the reference securities underlying our CDS experienced principal losses and corresponding obligations of $17 million.

Counterparty Credit Risk

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. To mitigate this risk, we enter into agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the Federal Reserve Bank of New York as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated A or higher. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments.

At June 30, 2011, Redwood had outstanding derivative agreements with eight bank counterparties and Acacia entities had outstanding derivative agreements with five bank counterparties. At June 30, 2011, Redwood and the Acacia entities were in compliance with International Swaps and Derivatives Association (ISDA) agreements governing these open derivative positions.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 10. Other Assets

Other assets at June 30, 2011 and December 31, 2010, are summarized in the following table.

Other Assets

(In Thousands)	June 30, 2011	December 31, 2010
REO	$ 9,880	$ 14,481
Fixed assets and leasehold improvements	3,221	3,692
Derivative margin posted, net	23,913	16,233
Investment receivable	832	883
Income tax receivables	4,737	1,243
Prepaid expenses	722	1,973
Other	158	157
Total Other Assets	$ 43,463	$ 38,662

REO consists of foreclosed properties received in full satisfaction of defaulted real estate loans. The carrying value of REO at June 30, 2011 was $10 million, which includes the net effect of $6 million related to transfers into REO during the first six months of 2011, offset by $10 million of REO liquidations and less than $1 million of negative market valuation adjustments. At June 30, 2011, there were 66 REO properties recorded on our balance sheet, of which 64 were owned at Sequoia and two were owned at Redwood. At December 31, 2010, there were 83 REO properties recorded on our balance sheet, of which 81 were owned at Sequoia and two were owned at Redwood. Properties located in Michigan, Georgia, Ohio, and California accounted for 52% of our REO properties at June 30, 2011.

Derivative margin posted, net, was $24 million at June 30, 2011, resulting from margin calls from our swap counterparties that required us to post collateral.

Note 11. Short-term Debt

At June 30, 2011, we had short-term debt outstanding of $41 million. This debt matured and was repaid in July 2011. For the six months ended June 30, 2011, the average balance of short-term debt outstanding was $25 million, with a weighted average interest rate of 1.52%. At June 30, 2011, Redwood had a master repurchase agreement with one counterparty, and we were in compliance with the covenants under this agreement. At December 31, 2010, we had short-term debt outstanding of $44 million, which was repaid in March 2011.

Note 12. Asset-Backed Securities Issued

The Sequoia and Acacia securitization entities issue ABS to acquire assets from us and from third-parties. Each series of ABS issued consists of various classes that pay interest on a monthly or quarterly basis. Substantially all ABS issued pay variable rates of interest, which are indexed to one, three, or six-month LIBOR. Some ABS issued pay fixed rates of interest or pay hybrid rates, which are fixed rates that subsequently adjust to variable rates. ABS issued also include 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.

In March 2011, Redwood securitized $295 million of loans through our Sequoia program, with $281 million of ABS issued to third-parties. The components of ABS issued by consolidated securitization entities we sponsored at June 30, 2011 and December 31, 2010, along with other selected information, are summarized in the following table.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 12. Asset-Backed Securities Issued (continued)

Asset-Backed Securities Issued

The maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of ABS issued will often occur earlier than its stated maturity. At June 30, 2011, $3.79 billion of ABS issued ($6.43 billion principal value) had contractual maturities of over five years and $52 million of ABS issued ($52 million principal value) had contractual maturities of one to five years. Amortization of Sequoia deferred ABS issuance costs was $1 million for both the six months ended June 30, 2011 and 2010.

The following table summarizes the accrued interest payable on ABS issued at June 30, 2011 and December 31, 2010. Interest due on Sequoia ABS issued is settled monthly and interest due on Acacia ABS issued is settled quarterly.

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	June 30, 2011	December 31, 2010
Sequoia	$ 3,017	$ 2,356
Acacia	2,792	2,911
Total Accrued Interest Payable on ABS Issued	$ 5,809	$ 5,267

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at June 30, 2011 and December 31, 2010.

Collateral for Asset-Backed Securities Issued

	June 30, 2011			December 31, 2010		
(In Thousands)	Sequoia	Acacia	Total	Sequoia	Acacia	Total
Real estate loans	$3,654,932	$12,698	$3,667,630	$3,542,159	$19,850	$3,562,009
Real estate securities		293,308	293,308		327,919	327,919
REO	9,678		9,678	14,241		14,241

Restricted cash	283	30,287	30,570	331	21,790	22,121
Accrued interest receivable	6,824	2,352	9,176	6,264	2,735	8,999
Total Collateral for ABS Issued	$3,671,717	$338,645	$4,010,362	$3,562,995	$372,294	$3,935,289

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 13. Long-Term Debt

In 2006, we issued $100 million of trust preferred securities through Redwood Capital Trust I, a Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating coupon rate equal to three-month LIBOR plus 2.25% until the notes are redeemed, no later than January 30, 2037. The interest expense yield on our trust preferred securities was 2.61% and 3.28% for the six months ended June 30, 2011 and 2010, respectively. Including hedging costs, and amortization of deferred ABS issuance costs, our trust preferred securities yielded 6.86% for the six months ended June 30, 2011. The earliest optional redemption date without penalty is January 30, 2012. In December 2010, we repurchased $500 thousand principal amount of these trust preferred securities.

In 2007, we issued an additional $50 million of subordinated notes. These subordinated notes require quarterly distributions at a floating interest rate equal to three-month LIBOR plus 2.25% until the notes are redeemed, no later than July 30, 2037. The interest expense yield on our subordinated notes was 2.61% and 3.28% for the six months ended June 30, 2011 and 2010, respectively. Including hedging costs, and amortization of deferred ABS issuance costs, our subordinated notes yielded 6.86% for the six months ended June 30, 2011. The earliest optional redemption date without a penalty is July 30, 2012. In July 2009, we repurchased $10 million principal amount of this subordinated debt.

At both June 30, 2011 and December 31, 2010, the accrued interest payable balance on long-term Redwood debt was less than $1 million. There are no financial covenants associated with our long-term debt.

Note 14. Commitments and Contingencies

Lease Commitments

At June 30, 2011, we were obligated under non-cancelable operating leases with expiration dates through 2018 for $10 million. The majority of the future lease obligations relates to operating leases for our executive office that expire in 2013 and 2018. The total payments required under these leases are recognized as office rent expense on a straight-line basis over the lease terms. Operating lease expense was less than $1 million for both the six months ended June 30, 2011 and 2010.

The following table presents our future lease commitments at June 30, 2011.

Future Lease Commitments by Year

(In Thousands)	June 30, 2011
2011 (six months)	$ 971
2012	1,882
2013	1,439
2014	1,132
2015	1,166
2016 and thereafter	2,954
Total	$ 9,544

Leasehold improvements for our offices are amortized into expense over the ten-year lease term, expiring in 2013. The unamortized leasehold improvement balance was $2 million and $3 million, respectively, at June 30, 2011 and December 31, 2010.

Loss Contingencies Litigation

On December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I,

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 14. Commitments and Contingencies (continued)

Inc. (collectively, the FHLB-Seattle Defendants). The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, *et seq.*) and seeks to rescind the purchase of a mortgage pass-through certificate (or, residential mortgage backed securities, RMBS) issued through our Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction and purchased by the FHLB-Seattle. The FHLB-Seattle seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys fees and costs. On January 22, 2010, the case was removed to the United States District Court for the Western District of Washington (case number 2:10-cv-00132-RSM). The FHLB-Seattle moved to remand the case to state court on March 11, 2010. On June 10, 2010, the FHLB-Seattle filed an amended complaint in the District Court. On September 1, 2010, the District Court remanded the case to Washington state court. Subsequently, on October 18, 2010, the FHLB-Seattle Defendants filed, in Washington State Superior Court, motions to dismiss the FHLB-Seattle s complaint. Redwood Trust, Inc. and SRF additionally moved to dismiss the complaint for lack of personal jurisdiction. The FHLB-Seattle alleges that the FHLB-Seattle Defendants offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the credit quality of the mortgage loans that backed it. Among other things, the FHLB-Seattle alleges that the FHLB-Seattle Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. On June 23, 2011, the Washington State Superior Court ruled on most aspects of the FHLB-Seattle Defendants motions to dismiss. Though some grounds for dismissal remain pending, the Court has granted dismissal of the allegations relating to occupancy status and denied other grounds for dismissal. The Sequoia RMBS that is the subject of the FHLB-Seattle s claim was issued with an original principal amount of approximately $133 million and, as of June 30, 2011, had a remaining outstanding principal balance of approximately $30 million. We believe that this claim is without merit and we intend to defend the action vigorously. On July 19, 2011, the Court granted Redwood Trust, Inc. and SRF s motion to dismiss for lack of personal jurisdiction. Redwood Trust, Inc. does not know whether FHLB-Seattle will appeal or otherwise contest the dismissal, or file a claim in another jurisdiction. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Seattle s claim, Redwood indemnified the underwriters of this 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 for lack of personal jurisdiction. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On August 18, 2010, Redwood Trust, Inc. s subsidiary, SRF, received service of process with respect to a case filed on July 15, 2010 in Superior Court for the State of California in San Francisco (case number CGC-10-501610) by The Charles Schwab Corporation (Schwab). In the claim, Schwab is suing SRF and 26 other named defendants (collectively, the Schwab Defendants) in relation to RMBS sold or issued by the Schwab Defendants. With respect to

SRF, Schwab alleges a cause of action of negligent misrepresentation under California state law and seeks unspecified damages and attorneys fees and costs with respect to a RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction (which is the same securitization transaction at issue in the litigation initiated by the FHLB-Seattle described in the preceding paragraph). Among other things, Schwab alleges that the offering materials for this Sequoia RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. On September 8, 2010, the matter was removed to the United States District Court for the Northern District of California, Case No. C 10-04030SI. On October 1,

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 14. Commitments and Contingencies (continued)

2010, Schwab filed a motion to remand the matter to state court, which motion was granted on February 23, 2011. The Schwab Defendants have not yet responded to the complaint. The Sequoia RMBS that is the subject of Schwab s cause of action was issued with an original principal amount of approximately $14.8 million and, as of June 30, 2011, had a remaining outstanding principal balance of approximately $3.3 million. We believe that this case is without merit and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of Schwab s claim, Redwood indemnified the underwriters of this 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. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On July 12, 2010, two notices of Election to Void Sale of Securities pursuant to Illinois Securities Law (815 ILCS Section 5/13(A)) were received from the Federal Home Loan Bank of Chicago (FHLB-Chicago). In the notices, the FHLB-Chicago sought to void its purchase of two RMBS that were issued in 2006 by a securitization trust with respect to which Redwood Trust, Inc. s subsidiary, SRF, was the depositor. Subsequently, on October 15, 2010, the FHLB-Chicago filed a case in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the FHLB-Chicago Defendants) in relation to RMBS sold or issued by the FHLB-Chicago Defendants or by entities controlled by the FHLB-Chicago Defendants. In an amended complaint filed on March 16, 2011, FHLB-Chicago added as defendants Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc. With respect to Redwood Trust, Inc. and SRF, the FHLB-Chicago alleges that the offering materials for two RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2006-1 securitization transaction contained untrue and misleading statements and material representations in violation of Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law N.C.G.S.A. § 78A-8(2) & § 78A-56(a)), and alleges claims of negligent misrepresentations under Illinois common law. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of these RMBS and to collect interest on the original purchase price at the statutory interest rate of 10% per annum from the date of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys fees and costs. Among other things, the FHLB-Chicago alleges that the offering materials for this RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, (4) ratings assigned to this RMBS, and (5) due diligence performed on these mortgage loans. The first of these two Sequoia RMBS was issued with an original principal amount of approximately $105 million and, as of June 30, 2011, had a remaining outstanding principal balance of approximately $45 million. The second of these two Sequoia RMBS was issued with an original principal amount of approximately $379 million and, as of June 30, 2011, had a remaining outstanding principal balance of approximately $164 million. On March 27, 2011, the FHLB-Chicago Defendants moved to dismiss the amended complaint, which motions are now pending. We believe that this case is without merit, and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Chicago s claim, Redwood indemnified the underwriters of this 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. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

We cannot determine the outcome of any of the above-referenced litigation matters at this time or predict the results with certainty. We cannot be certain that any of these matters will not have a material adverse effect on our results of operations in any future period, and any loss and expense related to any of this litigation could have a material adverse impact on our consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2011
(Unaudited)

Note 14. Commitments and Contingencies (continued)

In accordance with FASB guidance on accounting for contingencies, 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. If, with respect to a matter, it is not both probable to result in liability and the amount of loss cannot be reasonably estimated (as is the case for each of the above-referenced litigation matters), FASB guidance on accounting for contingencies provides that an estimate of possible loss or range of loss be disclosed unless such an estimate cannot be made. There are numerous factors that make it difficult to meaningfully estimate possible loss or range of loss at this stage of these litigation matters, including that: the proceedings are in relatively early stages, 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 rescission and the related statutory interest rate, our belief that these litigations are without merit, and our intent to defend these actions vigorously. In addition, with respect to claims where damages are the requested relief, no amount of loss or damages has been specified. We also may have additional rights and/or obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters, which rights and obligations could offset or increase our losses. We are unable at this time to estimate the potential amount of any such offset or loss.

Note 15. Equity

The following table provides a summary of changes to stockholders equity for the three and six months ended June 30, 2011.

Stockholders Equity

(In Thousands)	Three Months Ended June 30, 2011	Six Months Ended June 30, 2011
Balance at beginning of period	$ 1,074,811	$ 1,064,753
Other changes in equity, net	1,987	4,231
Unrealized gains on securities and derivatives, net	(41,491)	(31,718)
Distributions to shareholders	(20,236)	(40,360)
Net income attributable to Redwood Trust, Inc.	9,439	27,604

Balance at End of Period	$ 1,024,510	$ 1,024,510

Accumulated Other Comprehensive Income

The following table provides a summary of the components of accumulated other comprehensive income at June 30, 2011 and December 31, 2010.

(In Thousands)	June 30, 2011	December 31, 2010
Net unrealized gains on real estate securities	$109,190	$137,360
Less: Unrealized losses attributable to noncontrolling interest		(4,164)
Net unrealized gains on real estate securities recognized in equity	109,190	141,524
Net unrealized losses on interest rate agreements accounted for as cash flow hedges	(28,569)	(29,185)
Total Accumulated Other Comprehensive Income	$80,621	$112,339

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 15. Equity (continued)

Noncontrolling Interest

Of the total equity recorded on our consolidated balance sheet at June 30, 2011, and December 31, 2010, $2 million and $11 million, respectively, is noncontrolling interest. Noncontrolling interest represents the aggregate limited partnership (LP) interests in the Fund held by third-parties. Income allocated to the noncontrolling interest is based on the 48% third-party LP ownership percentage. The ownership percentage is determined by dividing the number of units held by third-party LP investors by the total units outstanding.

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, 2011 and 2010.

Basic and Diluted Earnings Per Common Share

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands, Except Share Data)	2011	2010	2011	2010
Basic Earnings Per Common Share:				
Net income attributable to Redwood	$9,439	$28,601	$27,604	$75,444
Less: Dividends and undistributed earnings allocated to participating securities	192	795	729	2,111
Net income allocated to common shareholders	$9,247	$27,806	$26,875	$73,333
Basic weighted average common shares outstanding	78,324,057	77,800,642	78,176,767	77,739,279
Basic Earnings Per Common Share	$0.12	$0.36	$0.34	$0.94
Diluted Earnings Per Common Share:				
Net income attributable to Redwood	$9,439	$28,601	$27,604	$75,444
Less: Dividends and undistributed earnings allocated to participating securities	343	685	922	1,710
Net income allocated to common shareholders	$9,096	$27,916	$26,682	$73,734
Basic weighted average common shares outstanding	78,324,057	77,800,642	78,176,767	77,739,279

Net effect of dilutive equity awards	1,153,447	1,051,617	1,248,593	922,363
Diluted weighted average common shares outstanding	79,477,504	78,852,259	79,425,360	78,661,642
Diluted Earnings Per Common Share	$0.11	$0.35	$0.34	$0.94

For the three and six months ended June 30, 2011, there were 1,153,447 and 1,248,593, respectively, of dilutive equity awards determined under the two-class method. For the three and six months ended June 30, 2010, there were 1,051,617 and 922,363, respectively, of dilutive equity awards determined under the two-class method. We included participating securities in the calculation of diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method. For the three and six months ended June 30, 2011, the number of outstanding equity awards that were antidilutive totaled 686,037 and 675,529, respectively, under the two-class method. For the three and six months ended June 30, 2010, the number of outstanding equity awards that were antidilutive totaled 681,705 and 582,582, respectively, under the two-class method. There were no other participating securities during these periods.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 15. Equity (continued)

Stock Repurchases

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the six months ended June 30, 2011 and 2010, there were no shares acquired under the plan. At June 30, 2011, there remained 4,658,071 shares available for repurchase under this plan.

Note 16. Equity Compensation Plans

At June 30, 2011 and December 31, 2010, 1,182,611 and 1,052,826 shares of common stock, respectively, were available for grant under Redwood s Incentive Plan. The unamortized compensation cost under the Incentive Plan and the Employee Stock Purchase Plan totaled $15 million at June 30, 2011, as shown in the following table.

	Six Months Ended June 30, 2011					
(In Thousands)	Stock Options	Restricted Stock	Deferred Stock Units	Performance Stock Units	Employee Stock Purchase Plan	Total
Unrecognized compensation cost at beginning of period	$	$ 1,390	$ 14,420	$ 3,320	$	$ 19,130
Equity grants		48	847		120	1,015
Equity compensation cost		(255)	(3,882)	(569)	(60)	(4,766)
Unrecognized Compensation Cost at End of Period	$	$ 1,183	$ 11,385	$ 2,751	$ 60	$ 15,379

At June 30, 2011, the weighted average amortization period remaining for all of our equity awards was less than two years.

Stock Options

At June 30, 2011 and December 31, 2010, there were 455,115 and 459,115, respectively, of fully vested stock options outstanding. There was no aggregate intrinsic value for the options outstanding and exercisable at June 30, 2011.

For the six months ended June 30, 2011, there were no stock options exercised. For both the three and six months ended June 30, 2010, there were 11,500 stock options exercised with an intrinsic value or gain (fair market value less exercise price) of less than $1 million.

Restricted Stock

At June 30, 2011 and December 31, 2010, there were 102,116 and 119,071 shares, respectively, of restricted stock outstanding. Restrictions on these shares lapse through 2015. There were no restricted stock awards granted during the three months ended June 30, 2011. There were 1,647 restricted stock awards granted during the six months ended June 30, 2011.

Deferred Stock Units

At June 30, 2011 and December 31, 2010, there were 1,958,431 and 2,351,804, respectively, DSUs outstanding, of which 918,461 and 1,042,341, respectively, had vested. There were 55,206 and 60,167 DSUs granted during the three and six months ended June 30, 2011, respectively. During the three and six months ended June 30, 2011, the number of DSUs distributed to participants in the Executive Deferred Compensation

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 16. Equity Compensation Plans (continued)

Plan (EDCP) totaled 453,541. Cash distributions to EDCP participants of some of their previously deferred compensation invested and vested matching totaled less than $1 million during both the three and six months ended June 30, 2011.

In March 2010, vesting of 376,564 DSUs previously awarded to Mr. George E. Bull, III, was accelerated to June 1, 2010, in connection with the announcement that he would retire from serving as Chief Executive Officer in the second quarter of 2010. We recorded a $4 million equity compensation expense during the three months ended March 31, 2010, related to the modification of these DSUs. No such equity award modifications occurred during the six months ended June 30, 2011.

Performance Stock Units

At both June 30, 2011 and December 31, 2010, there were 243,754 PSUs outstanding, none of which had vested. These PSUs cliff vest, if at all, on November 30, 2013, the third anniversary of their grant date, with vesting contingent on total stockholder return (change in our common stock price plus dividends paid on our common stock) over the three-year vesting period (Three-Year TSR). The number of underlying shares of our common stock that will vest on November 30, 2013, will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the number of these PSUs originally granted on November 30, 2010, adjusted (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period.

Employee Stock Purchase Plan

The ESPP allows a maximum of 200,000 shares of common stock to be purchased in aggregate for all employees. At June 30, 2011 and December 31, 2010, 134,439 and 121,643 shares have been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

Note 17. Operating Expenses

Components of our operating expenses for the three and six months ended June 30, 2011 and 2010 are presented in the following table.

Operating Expenses

(In Thousands)	Three Months Ended June 30, 2011	2010	Six Months Ended June 30, 2011	2010
Fixed compensation expense	$ 3,797	$ 3,890	$ 7,942	$ 8,080
Variable compensation expense	646	1,303	1,246	3,183
Equity compensation expense	2,707	2,077	4,766	8,136
Total compensation expense	7,150	7,270	13,954	19,399
Systems	1,915	1,734	3,854	3,311
Office costs	1,582	1,783	3,322	3,548
Accounting and legal	908	45	1,544	1,511
Other operating expenses	532	395	926	764
Total Operating Expenses	$ 12,087	$ 11,227	$ 23,600	$ 28,533

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2011 (Unaudited)

Note 18. Taxes

For each of the three and six months ended June 30, 2011 and 2010, we recognized a provision for income taxes of less than $1 million. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at June 30, 2011 and 2010.

Reconciliation of Statutory Tax Rate to Effective Tax Rate

	June 30, 2011	2010
Federal statutory rate	34.0 %	34.0 %
State statutory rate, net of Federal tax effect	7.2 %	7.2 %
Differences in taxable income from GAAP income	(41.1)%	(41.1)%
Effective Tax Rate	0.1 %	0.1 %

We assessed our tax positions for all open tax years (Federal years 2006 to 2009, State years 2005 to 2009) and concluded at June 30, 2011 and December 31, 2010, that we have no material unrecognized tax liabilities.

Note 19. Recent Developments

During July 2011, we transferred $365 million of residential securities (at market value) into a re-securitization trust sponsored by Credit Suisse, and received, as consideration, subordinated securities issued by the trust, as well as net cash proceeds of $243 million. We anticipate consolidating this entity for financial reporting purposes, pending our final interpretation of applicable GAAP pertaining to the transfer of financial assets and consolidation of VIEs. Consolidation of this entity would result in our reporting an additional $245 million of ABS issued, reflecting that for GAAP purposes this transaction represents a secured financing. The Credit Suisse re-securitization trust to which we transferred residential securities is independent of Redwood and its assets and liabilities are not legally owned by and are not obligations of Redwood.

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

Introduction

Redwood Trust, Inc., together with its subsidiaries, is a financial institution that seeks to invest in real estate related assets that have the potential to provide attractive cash flows over a long period of time and support our goal of distributing attractive levels of dividends to our stockholders. For tax purposes, we are structured as a real estate investment trust (REIT). We are able to pass through substantially all of our earnings generated at our REIT to our stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries. Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

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

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

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

Cautionary Statement

This Quarterly Report on Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as anticipate, estimate, will, should, expect, believe, intend, seek, plan and similar expressions forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010, under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in

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reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) our belief that rebuilding our core residential and commercial businesses of managing, facilitating, and investing in mortgage credit offers the best long-term opportunity to increase earnings and dividends and to build franchise value for our shareholders; (ii) our competitive position and our ability to compete in the future, including our ability to effectively compete to acquire residential mortgage loans and our statement that we are making steady progress in building relationships with loans sellers and our ability to compete to originate and acquire commercial real estate loans; (iii) our future investment strategy and our ability to find attractive investments and future trends relating to our pace of acquiring or selling assets, including, without limitation, statements relating to our efforts to acquire residential mortgage loans, make commercial real estate investments, and potentially leverage the capital we have invested in commercial real estate investments without taking funding risk; (iv) our plan to acquire the $201 million of residential mortgage loans that, as of the end of the second quarter of 2011, we planned to purchase and our plan to acquire additional residential mortgage loans that we plan in the future to acquire after the end of the second quarter of 2011, including the $198 million of loans we plan to acquire in the future as of July 29, 2011; (v) our belief that our hedging strategy relating to loans acquired for future securitization has worked well in the face of significant interest rate volatility and that we would expect to recover all or a portion of any loss on hedges that relate to mortgage loans we are holding for future securitization over time through higher interest income; (vi) our belief that our loan conduit business and the systems and operational infrastructure we have in place for our loan conduit business can handle a substantially higher volume of business without a significant increase in our cost base and our statement that we believe the scale of the operational infrastructure we have in place will position us well for the future; (vii) future securitization transactions, the timing of the completion of those future securitization transactions, and the number and size of such transactions we expect to complete in 2011 and future periods, which future securitizations may not be completed when planned or at all, and, more generally, statements regarding the likelihood and timing of, and our participation in, future securitization transactions and our ability to finance loan acquisitions through the execution of securitization transactions; (viii) our expectation that new Sequoia securitization entities will represent a larger portion of our balance sheet in the future; (ix) our statement that we expect to reverse, through positive adjustments to earnings in future periods $6 million of loan loss reserves that relate to eleven Sequoia securitization entities in future periods upon the retirement or deconsolidation of those entities; (x) our expectations of future levels of our securities purchase and sale activity and our plans to invest our excess capital and our statements relating to the cash flows we expect to receive from our investments in securities; (xi) that we do not anticipate considering raising equity capital financing before 2012, that we do not plan to raise equity capital unless we believe we have attractive investment opportunities that exceed our investment capacity, our estimates of our short-term borrowing capacity, our investment capacity, and our excess capital, our statements regarding our ability to access additional short-term borrowings and to access capital through re-securitization transactions or other forms of debt financing, and our expectation that we will have established a warehouse borrowing facility to finance the acquisition of residential mortgage loans in the next several months; (xii) future market and economic conditions, including, without limitation, future conditions in the residential and commercial real estate markets and related financing markets, and the related potential opportunities for our residential and commercial businesses; (xiii) that the size of the jumbo residential mortgage market is potentially vast and could represent an opportunity that exceeds the current capital we have to invest and the potential that regulatory reforms could increase the size of the jumbo mortgage market, our statement that these trends could present a growth opportunity for us and our statements regarding our beliefs about our competitive advantages; (xiv) our beliefs about, and our outlook for, the future direction of housing market fundamentals, including, without limitation, home prices, demand for housing, delinquency rates, foreclosure rates, prepayment rates, inventory of homes for sale, and mortgage interest rates and their potential impact on our business and results of operations and our belief that the housing market is in the process of forming a bottom and our expectation that housing, in general, will not be a significantly appreciating asset class for several years; (xv) our beliefs about the future direction of commercial real estate fundamentals and statements regarding the competitive landscape for and availability of financing for commercial real estate; (xvi) our estimate that our commercial real estate loan originations are likely to be in the range of $25 million to $50

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million per quarter, and statements regarding the future of the CMBS market; (xvii) statements relating to the impact of recent and future legislative and regulatory changes that affect our business, the regulation of securitization transactions, and the mortgage finance markets, the manner in which the reform of the GSEs, including Fannie Mae and Freddie Mac, may take place and the timeline for that reform, and our statements that GSE reform and bank regulatory capital reforms could result in a larger portion of the mortgage market being available to us; (xviii) our expectations regarding credit reserves, credit losses, the adequacy of credit support, and impairments and their impact on our investments (including as compared to our original expectations and credit reserve levels) and the timing of losses and impairments, and statements that the amount of credit reserves we designate may require changes in the future; (ixx) that we continue to expect interest income to be derived primarily from our senior residential securities and that in future periods we expect our residential and commercial loan businesses to expand and contribute more significantly to interest income; (xx) expectations regarding future interest income, future earnings, future earnings volatility, and future trends in operating expenses and the factors that may affect those trends; (xxi) our board of directors intention to pay a regular dividend of $0.25 per share per quarter in 2011; and (xxii) our expectations relating to tax accounting, including our expectation that we will realize a taxable loss for the full year 2011, and our anticipation of additional credit losses for tax purposes in 2011 and future periods and the level of those losses.

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

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

Our Business

Redwood invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in securities backed by real estate loans. We seek to invest in assets that have the potential to generate sufficient long-term cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time.

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Our primary source of income is typically net interest income, which consists of the interest income we earn from our investments less the interest expenses we incur on borrowed funds and other liabilities. We assume a range of risks in our investments and the level of risk is influenced by the manner in which we finance our purchases of, and derive income from, our investments.

Our investments include residential and commercial real estate loans and securities backed by residential and commercial loans. The securities include both senior securities and subordinate securities. Senior securities are those interests in a securitization that have the first right to cash flows and are last to absorb losses. Subordinate securities are those interests in a securitization that have the last right to cash flows and are first in line to absorb losses. We may also invest in re-REMIC securities, or securities that were created through the resecuritization of certain senior interests in residential mortgage securitizations to provide additional credit support to those interests.

Residential securities we invest in are generally acquired by us from third-parties or by retaining mortgage-backed securities issued by Sequoia securitization trusts, which are securitization entities we sponsor. The process of sponsoring a Sequoia securitization includes the acquisition of residential loans, which we generally fund with equity and short-term debt during the accumulation period, the transfer of a pool of those loans to a Sequoia securitization entity, and the structuring and issuance by the Sequoia securitization entity of mortgage-backed securities collateralized by that pool of loans. Senior securities issued by Sequoia securitization entities are generally issued to third-parties, while the subordinate securities issued by these entities are generally retained by us.

Historically, we have also sponsored other entities: a private limited partnership fund that we manage, the Redwood Opportunity Fund, LP (the Fund), and Acacia securitization entities that we also manage. The Fund and the Acacia securitization entities generally invested in a variety of real estate related assets. Our investments in these entities are currently financed with equity and long-term debt. We are not currently seeking to sponsor other entities like the Fund and the Acacia securitization entities.

Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not obligations of Redwood, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities. For financial reporting purposes, we are required to consolidate the assets of the Fund and the assets and liabilities of many of the Sequoia and Acacia securitization entities we have sponsored.

The commercial real estate loans we invest in are primarily originated by us and any commercial mortgage-backed securities we invest in are acquired from third-parties. Our commercial investments are currently financed with equity and long-term debt.

For tax purposes, we are structured as a REIT. As a REIT, we are able to pass through substantially all of our earnings to our stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries.

Business Update   Second Quarter 2011

We continue to believe that rebuilding our core residential and commercial businesses of managing, facilitating, and investing in mortgage credit offers the best long-term opportunity to increase earnings and dividends and to build franchise value for our shareholders. We believe that these businesses play to our competitive strengths and the potential market opportunity is large. The time it takes to realize that potential opportunity, however, remains uncertain   especially for our residential mortage loan business.

GAAP earnings for the second quarter of 2011 were $9 million or $0.11 per share, down from $18 million or $0.22 per share reported for the first quarter of 2011. We are not satisfied with these results, which are presented in more detail throughout this quarter s *Management s Discussion and Analysis of Financial Condition and Results of Operations*. While fully investing our excess capital should improve our results going forward, it is not the sole answer to enhancing long-term profitability and growth. We have structured our residential loan business to operate on more volume than has recently been available at the right terms. As a result, our operating costs are high relative to the net revenues we can earn from our invested capital without taking undue risk. Ultimately, we believe the scale of our operating infrastructure will position us to invest more capital and better leverage our cost structure, while continuing to manage risk.

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Residential Mortgage Loan Business

We continued to sign up more sellers and expand our residential loan business during the second quarter. We deployed $152 million in capital during the quarter purchasing residential loans. At June 30, 2011, we held $203 million in residential mortgage loans and we had plans to purchase an additional $201 million in residential mortgage loans. By July 29, 2011, the total of loans owned plus those we planned to purchase had risen to $500 million from $404 million at June 30, 2011. We continue to target two additional securitizations in 2011, although this goal seems more challenging than it did a few months ago.

Our residential loan conduit and credit investment businesses are structured to work well together. Our goal for these businesses is to source high-quality loans on an ongoing basis that we can securitize, thereby creating a flow of attractive credit investments for us, and senior investments for investors in AAA-rated securities. To achieve this goal, we believe we need to continue to demonstrate our ability to bring the highest value to borrowers, lenders, and investors. In addition, we need to continue to be recognized as a real and reliable counterparty by loan sellers.

As a result, we have made upfront capital investments in sales and back-office personnel, operational infrastructure, and technology. And even in the current market dominated by government financing, we are making steady progress in building lasting relationships with loan sellers and investors. Furthermore, we believe our loan conduit business can handle substantially higher volume without a significant increase in our cost base. The challenge remains that until we put more capital to work in residential credit investments, the results of our residential loan business will be a drag on earnings.

Residential Portfolio Business

We began the second quarter with a continuation of the trends in the secondary market for residential mortgage securities that had essentially been in place since early 2009: rising prices, improving liquidity, and tightening bid-ask spreads. In fact, the Federal Reserve s Maiden Lane portfolio sales of residential securities acquired during the financial crisis were heralded by most market participants (including us) as a welcome source of supply that would help tighten bid-ask spreads. Our prediction turned out to be wrong. As the quarter unfolded, a steady stream of bad news domestic economic trends, the end of the Federal Reserve s second quantitative easing program (QE 2), the looming debt ceiling problem in the United States, and the debt crisis in Europe contributed to an abrupt turn in market dynamics. Investors pulled back from higher risk securities and bid-ask spreads widened. The trend of consistently higher prices was interrupted in the second quarter of 2011, with RMBS prices falling across the board with the sharpest declines for the riskiest securities.

We welcome the change in the market where higher quality securities outperform riskier securities. We were fortunate to have made some select credit risk sales prior to the market turn and to have found selected opportunities to reinvest at more attractive levels as the second quarter unfolded. Specifically, we put $33 million in capital to work adding new securities to our portfolio, while we sold $9 million in securities at Redwood. We continue to feel good about the expected cash flow from the securities we own.

Early in the second quarter, we completed our sales of the remaining Fund positions. We expect to finish our accounting for the Fund and distribute final cash sometime in the third quarter. The Fund did not deliver returns in the range we initially expected, as it was difficult to overcome the decision to launch the Fund in late 2007, which clearly turned out to be poor timing. We feel good that our patience and price discipline in liquidating positions helped us to get nearly 100 cents on the dollar back for the investors in the Fund.

Commercial Loan Business

During the second quarter, we put $29 million of capital to work in three separate commercial real estate loans. Our portfolio of commercial real estate loans consists of $71 million in loans on stabilized multifamily properties, central business district office buildings in major markets, necessity/grocery-anchored retail centers, and hotels with strong brands and operators. We continue to expect to originate in the range of $25 million to $50 million per quarter. Our portfolio has a weighted average maturity of over five years and an average unlevered yield of approximately 10.5%.

Transaction volumes have increased in 2011 for commercial mortgage-backed securities (CMBS) lenders, portfolio lenders, and government-sponsored enterprises (GSEs). Portfolio lenders including life insurance

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companies and banks are posting strong new origination results for targeted assets. The GSEs continue to dominate multi-family lending, though life insurance companies, banks, and now CMBS lenders are making inroads. While most prognosticators continue to expect volumes to expand and CMBS aggregators in particular are staffing up, there are some signs of stress in the market. Late in the second quarter and into July, 2011, increasingly risk-averse investors in CMBS transactions began demanding higher yields and better terms. For instance, in a recently marketed new issue CMBS transaction, investors insisted on increased subordination levels, ignoring the levels that had been set by the rating agencies involved in the transaction. These developments could help reinforce discipline in the marketplace, which would be constructive for commercial property financings over time.

Outlook

We see signs that things are slowly moving in the right direction for private market finance of residential mortgages. Still, we are not idly waiting for external factors to change. We continue to work hard at building our franchises and growing the businesses where we can create value. We are focused on buying loans from high quality sellers, realizing that we may not gain significant traction before 2012. While we recognize that the pace of progress is not ideal, we continue to execute our strategy and believe we are moving in the right direction.

The federal government continues to subsidize over 90% of all new residential mortgage originations and large banks can easily finance the remainder. As long as these conditions persist, opportunities to provide mortgage financing through private securitization for institutional investors that have traditionally invested in triple-A rated RMBS, and credit investors such as Redwood, remain subdued. Many real estate agents, home builders, and banks appear to benefit from such a status quo. Our strategic outlook, however, is that over time the current outsized role of government support for the $9.6 trillion residential mortgage market is simply not sustainable, especially in light of the painfully heated debates throughout 2011 over raising the $14.3 trillion federal debt ceiling. As the government eventually and gradually withdraws support for mortgage financing, we believe private capital (outside of banks) will be called upon to step in and fill the void.

There are encouraging reforms being undertaken by policymakers and regulators to pave the way for the return of private mortgage financing, albeit at a slow pace. The Obama Administration s Reforming America s Housing Finance Market whitepaper calls for the wind down of Fannie Mae and Freddie Mac on a responsible timeline. The first step toward this goal could happen on October 1, 2011, when the high-cost government conforming loan limit at Fannie Mae and Freddie Mac is scheduled by law to go from $729,750 to $625,500. We believe it is probable that the loan limit reduction occurs as scheduled. However, we expect pro-status quo forces to continue advocating against this reduction up to the point it is scheduled to occur, perpetuating an element of uncertainty to the existing timeline for reform.

Attracting institutional investors back to buying private AAA-rated RMBS is essential to bringing private mortgage financing back. There are several regulatory and industry reform efforts underway to meet the demands of these investors. Initiatives to establish new servicing standards and practices, strengthen structural investor protection mechanisms (in particular, around representations and warranties), improve alignments of interests, and increase transparency are all underway. As part of this process, we have been actively engaged with policymakers, regulators, and industry representatives at the center of these debates.

If banks decide to become more active sellers of non-conforming residential mortgage loans, that would also add to the size of our opportunity. Strengthening this possibility is the stricter regulatory environment and higher capital requirements (as proposed under Basel III) that banks will face as they re-evaluate how they participate in the mortgage market going forward.

Our opportunity in commercial real estate investments is very different than that in our residential business. In fact, the commercial market is largely unregulated relative to the residential market. Private capital drives the trends in all commercial sectors, with the exception of multi-family finance (currently dominated by Fannie Mae and Freddie Mac). As a result, we are not slowed by a government-dominated market waiting for the private sector role to grow. Rather, our effort to expand our commercial business is centered on building a team and a franchise, focusing on sound underwriting, and remaining patient as opportunities manifest themselves. We continue to originate mezzanine loans alongside senior loans extended by banks and insurance companies. We believe we can create opportunities to invest long-term capital and

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earn attractive returns in this business going forward, potentially leveraging capital without taking funding risk. We believe we have good relationships with borrowers, senior lenders, and brokers who appreciate our flexibility, responsiveness, and reliability.

Summary of Results of Operations

Net Income

Our reported GAAP net income was $9 million ($0.11 per share) for the second quarter of 2011, as compared to $29 million ($0.35 per share) for the second quarter of 2010. We declared regular quarterly dividends of $0.25 per share for both the second quarter of 2011 and 2010.

The following table presents the components of our GAAP net income for the three and six months ended June 30, 2011 and 2010.

Table 1 Net Income

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands, Except Share Data)	2011	2010	2011	2010
Interest income	$52,955	$56,570	$107,288	$115,288
Interest expense	(23,633)	(21,164)	(45,606)	(39,346)
Net interest income	29,322	35,406	61,682	75,942
Provision for loan losses	(1,581)	(4,321)	(4,389)	(13,797)
Market valuation adjustments, net	(11,147)	(7,125)	(16,887)	(18,362)
Net interest income after provision and market valuation adjustments	16,594	23,960	40,406	43,783
Operating expenses	(12,087)	(11,227)	(23,600)	(28,533)
Realized gains on sales and calls, net	5,834	16,080	9,699	60,417
Provision for income taxes	(14)	(26)	(28)	(52)
Less: Net income (loss) attributable to noncontrolling interest	888	186	(1,127)	171
Net Income	$9,439	$28,601	$27,604	$75,444
Diluted weighted average common shares outstanding	79,477,504	78,852,259	79,425,360	78,661,642
Net earnings per share	$0.11	$0.35	$0.34	$0.94

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Net Interest Income after Provision and Market Valuation Adjustments (MVA)

Net interest income after provision and MVA was $17 million for the second quarter of 2011, as compared to $24 million for the second quarter of 2010, a decrease of $7 million. This decrease was primarily due to a decline in net interest income of $6 million at Other Consolidated Entities. The remaining $1 million decline was the net effect of a decline in provision for loan loss expense and an increase in negative market valuation adjustments.

The following table details the components of market valuation adjustments for the three and six months ended June 30, 2011 and 2010.

Table 2 Components of MVA

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2011	2010	2011	2010
Commercial real estate loans (fair value)	$ 1,323	$ 2,978	$ 1,542	$ 7,344
Residential real estate loans (held-for-sale)	8	296	11	176
Trading securities	(9,594)	6,330	10,322	18,479
Impairment on AFS securities	(1,466)	(4,216)	(4,088)	(6,162)
REO	(244)	(1,285)	(1,162)	(1,359)
Risk management derivatives	(18,554)	(22,485)	(16,755)	(42,844)
ABS issued Acacia	17,380	11,257	(6,757)	6,004
Total Market Valuation Adjustments, Net	$ (11,147)	$ (7,125)	$ (16,887)	$ (18,362)

Market valuation adjustments, net, were negative $11 million for the second quarter of 2011, as compared to negative $7 million for the second quarter of 2010, an increase in negative market valuations of $4 million. This increase was the result of a net decline of $3 million in the value of trading securities and derivatives at Redwood and a net decline of $1 million at other consolidated entities.

In order to manage certain risks associated with residential and commercial loans we own or plan to acquire at Redwood, we may enter into various interest-rate derivatives, since the value of our loans changes with the level of interest rates. When we incur a gain or loss on these derivatives due to a change in interest rates, this amount is generally intended to offset a corresponding change in the value of the loans. For financial reporting purposes, the periodic gain or loss on derivatives classified as trading instruments is reflected in our consolidated statements of income as they are incurred, while any corresponding change in the value of the loans may be taken through lower or higher interest income over time. Thus, while risk management derivatives are intended to protect economic values, the accounting treatment can result in unavoidable periodic mismatches that affect our reported results. See *Market Valuation Adjustments (MVA) at Redwood (Parent) Trading Securities and Derivatives* below.

Operating Expenses

Operating expenses were $12 million and $11 million for the second quarters of 2011 and 2010, respectively. This increase was the result of an increase in accounting and legal fees of $1 million.

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Realized Gains on Sales and Calls, Net

The following table details the components of realized gains on sales and calls, net, for the three and six months ended June 30, 2011 and 2010.

Table 3 Realized Gains on Sales and Calls, Net

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2011	2010	2011	2010
Net gains on sales of real estate securities	$ 5,186	$ 15,811	$ 9,142	$ 53,189
Net gains on repurchase of Sequoia ABS				6,959
Net gains on extinguishment of debt	247	278	247	278
Net gains on calls				