REDWOOD TRUST INC
Form 10-Q
November 07, 2014
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UNITED STATES OF AMERICA

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended: September 30, 2014
OR

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

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

Commission File Number 1-13759

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

Not Applicable

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

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

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

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

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

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

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

Common Stock, $0.01 par value per share	83,283,922 shares outstanding as of November 3, 2014

REDWOOD TRUST, INC.

2014 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(In Thousands, Except Share Data) (Unaudited)	September 30, 2014	December 31, 2013
ASSETS		
Residential loans, held-for-sale, at fair value	$ 1,502,429	$ 404,267
Residential loans, held-for-investment, at fair value	238,651	-
Residential loans, held-for-investment	1,546,507	1,762,167
Commercial loans, held-for-sale, at fair value	104,709	89,111
Commercial loans, held-for-investment (includes $70,712 and $0 at fair value)	393,288	343,344
Real estate securities, at fair value	1,394,985	1,682,861
Mortgage servicing rights, at fair value	135,152	64,824
Cash and cash equivalents	149,617	173,201
Total earning assets	5,465,338	4,519,775
Restricted cash	455	398
Accrued interest receivable	15,261	13,475
Derivative assets	7,756	7,787
Deferred securities issuance costs	10,190	13,453
Other assets	112,768	53,640
Total Assets (1)	$ 5,611,768	$ 4,608,528
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$ 1,887,688	$ 862,763
Accrued interest payable	10,480	6,366
Derivative liabilities	38,263	18,167
Accrued expenses and other liabilities	48,239	48,704
Deferred tax liability	7,316	7,316
Asset-backed securities issued	1,656,202	1,942,962
Long-term debt (includes $66,146 and $0 at fair value)	696,902	476,467
Total liabilities (1)	4,345,090	3,362,745

Equity				
Common stock, par value $0.01 per share, 180,000,000 shares authorized; 83,284,392 and 82,504,801 issued and outstanding		833		825
Additional paid-in capital		1,768,612		1,760,899
Accumulated other comprehensive income		159,771		148,766
Cumulative earnings		879,745		806,298
Cumulative distributions to stockholders		(1,542,283)		(1,471,005)
Total equity		1,266,678		1,245,783
Total Liabilities and Equity	$	5,611,768	$	4,608,528

(1) Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At September 30, 2014 and December 31, 2013, assets of consolidated VIEs totaled $2,013,807 and $2,299,576, respectively, and liabilities of consolidated VIEs totaled $1,657,782 and $1,944,911, respectively. See *Note 4* for further discussion.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data) (Unaudited)	**Three Months Ended September 30, 2014**	**2013**	**Nine Months Ended September 30, 2014**	**2013**
Interest Income				
Residential loans	$ 19,280	$ 17,027	$ 45,539	$ 53,497
Commercial loans	12,603	10,740	34,204	30,534
Real estate securities	31,461	29,649	97,062	84,480
Cash and cash equivalents	7	4	15	153
Total interest income	63,351	57,420	176,820	168,664
Interest Expense				
Short-term debt	(8,441)	(5,227)	(17,409)	(13,721)
Asset-backed securities issued	(7,838)	(9,604)	(24,462)	(30,815)
Long-term debt	(7,071)	(6,894)	(21,689)	(16,908)
Total interest expense	(23,350)	(21,725)	(63,560)	(61,444)
Net Interest Income	40,001	35,695	113,260	107,220
Reversal of provision (provision) for loan losses	1,596	(1,727)	629	(493)
Net Interest Income After Provision	41,597	33,968	113,889	106,727
Noninterest Income				
Mortgage banking activities, net	17,872	(8,698)	23,950	85,562
Mortgage servicing rights income, net	5,821	3,113	4,650	14,681
Other market valuation adjustments, net (1)	(3,706)	462	(13,966)	(6,099)
Realized gains, net	8,532	10,469	10,687	23,291
Total noninterest income, net	28,519	5,346	25,321	117,435
Operating expenses	(21,406)	(22,320)	(63,660)	(66,937)
Other income	1,600	-	1,600	-
Net income before provision for income taxes	50,310	16,994	77,150	157,225
(Provision for) benefit from income taxes	(5,213)	4,935	(3,703)	(9,113)
Net Income	$ 45,097	$ 21,929	$ 73,447	$ 148,112
Basic earnings per common share	$ 0.53	$ 0.26	$ 0.87	$ 1.76
Diluted earnings per common share	$ 0.50	$ 0.25	$ 0.84	$ 1.65
	$ 0.28	$ 0.28	$ 0.84	$ 0.84

Regular dividends declared per common share				
Basic weighted average shares outstanding	83,017,534	82,201,473	82,722,079	81,888,231
Diluted weighted average shares outstanding	96,956,232	84,422,039	85,031,130	93,233,865

(1) For the three months ended September 30, 2014, other-than-temporary impairments were $188, all of which was recognized through the income statement. For the three months ended September 30, 2013, there were no other-than-temporary impairments. For the nine months ended September 30, 2014, other-than-temporary impairments were $4,774, of which $565 were recognized through the Income Statement and $4,209 were recognized in Accumulated Other Comprehensive Income. For the nine months ended September 30, 2013, other-than-temporary impairments were $1,666, all of which was recognized through the income statement.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

(In Thousands)	**Three Months Ended September 30,**		**Nine Months Ended September 30,**	
(Unaudited)	**2014**	**2013**	**2014**	**2013**
Net Income	$ 45,097	$ 21,929	$ 73,447	$ 148,112
Other comprehensive income (loss):				
Net unrealized gain (loss) on available-for-sale securities	1,849	(633)	35,078	(29,615)
Reclassification of unrealized (gain) loss on available-for-sale securities to net income	(6,409)	(6,962)	(6,750)	(19,211)
Net unrealized (loss) gain on interest rate agreements	(3,258)	4,018	(17,454)	25,043
Reclassification of unrealized loss on interest rate agreements to net income	32	62	131	219
Total other comprehensive income (loss)	(7,786)	(3,515)	11,005	(23,564)
Total Comprehensive Income	$ 37,311	$ 18,414	$ 84,452	$ 124,548

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

For the Nine Months Ended September 30, 2014

ousands, Except Share Data) lited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Tota
ber 31, 2013	82,504,801	$ 825	$ 1,760,899	$ 148,766	$ 806,298	$ (1,471,005)	$ 1,245
ome	-	-	-	-	73,447	-	73
omprehensive income	-	-	-	11,005	-	-	11
ce of common stock:							
d reinvestment & stock e plans	336,810	4	6,051	-	-	-	6
ee stock purchase and e plans	442,781	4	(7,272)	-	-	-	(7
sh equity award compensation	-	-	8,934	-	-	-	8
on dividends declared	-	-	-	-	-	(71,278)	(71
ber 30, 2014	83,284,392	$ 833	$ 1,768,612	$ 159,771	$ 879,745	$ (1,542,283)	$ 1,266

For the Nine Months Ended September 30, 2013

ousands, Except Share Data) lited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Tota
ber 31, 2012	81,716,416	$ 817	$ 1,744,554	$ 138,332	$ 633,052	$ (1,376,591)	$ 1,140
ome	-	-	-	-	148,112	-	148
omprehensive income (loss)	-	-	-	(23,564)	-	-	(23
ce of common stock:							
nd reinvestment & stock se plans	374,371	4	7,073	-	-	-	7
yee stock purchase and ve plans	297,715	3	(5,390)	-	-	-	(5
sh equity award compensation	-	-	11,443	-	-	-	11
on dividends declared	-	-	-	-	-	(70,675)	(70
ber 30, 2013	82,388,502	$ 824	$ 1,757,680	$ 114,768	$ 781,164	$ (1,447,266)	$ 1,207

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) (Unaudited)	Nine Months Ended September 30, 2014	 2013
Cash Flows From Operating Activities:		
Net income	$ 73,447	$ 148,112
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(26,248)	(18,060)
Depreciation and amortization of non-financial assets	369	310
Purchases of held-for-sale loans	(6,844,403)	(6,864,921)
Proceeds from sales of held-for-sale loans	5,328,901	6,263,058
Principal payments on held-for-sale loans	19,648	9,467
Net settlements of derivatives	(22,776)	55,694
Provision (reversal of provision) for loan losses	(629)	493
Non-cash equity award compensation expense	8,934	11,443
Market valuation adjustments, net	(1,787)	(76,425)
Realized gains, net	(10,687)	(34,322)
Net change in:		
Accrued interest receivable and other assets	(57,806)	2,374
Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities	(266)	17,378
Net cash used in operating activities	(1,533,303)	(485,399)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(65,584)	(63,071)
Proceeds from sales of held-for-investment loans	-	440
Principal payments on held-for-investment loans	267,425	415,576
Purchases of real estate securities	(132,393)	(142,628)
Proceeds from sales of real estate securities	457,131	204,462
Principal payments on real estate securities	144,598	124,030
Purchase of mortgage servicing rights	(41,834)	(3,106)
Net change in restricted cash	(57)	(34)
Net cash provided by investing activities	629,286	535,669
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	5,615,317	5,745,892
Repayments on short-term debt	(4,643,308)	(5,459,511)
Repayments on asset-backed securities issued	(286,248)	(465,986)
Deferred securities issuance costs	-	(9,184)
Proceeds from issuance of long-term debt	272,937	332,119

Repayments on long-term debt		(685)		(14)
Net settlements of derivatives		(2,507)		(9)
Net proceeds from issuance of common stock		3,840		6,452
Taxes paid on equity award distributions		(7,635)		(5,789)
Dividends paid		(71,278)		(70,675)
Net cash provided by financing activities		880,433		73,295
Net (decrease) increase in cash and cash equivalents		(23,584)		123,566
Cash and cash equivalents at beginning of period		173,201		81,080
Cash and cash equivalents at end of period	$	149,617	$	204,646
Supplemental Cash Flow Information:				
Cash paid during the period for:				
Interest	$	57,047	$	60,394
Taxes		1,399		3,397
Supplemental Noncash Information:				
Real estate securities retained from loan securitizations	$	126,009	$	370,498
Retention of mortgage servicing rights from loan securitizations and sales		30,962		41,128
Transfers from loans held-for-sale to loans held-for-investment		278,913		-
Transfers from residential loans to real estate owned		4,753		3,448

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries, focuses on investing in mortgage- and other real estate-related assets and engaging in residential and commercial mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential and commercial mortgage banking activities.

Our primary sources of income are net interest income from our investment portfolios and noninterest income from our mortgage banking activities. Net interest income consists of the interest income we earn on investments less the interest expense we incur on borrowed funds and other liabilities. Income from mortgage banking activities consists of the profit we seek to generate through the acquisition or origination of loans and their subsequent sale or securitization. References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. consolidated subsidiaries, unless the context otherwise requires.

We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments.

Our residential mortgage banking segment primarily consists of operating a mortgage loan conduit that acquires residential loans from third-party originators for subsequent sale through securitization or as whole loans. Jumbo loans we acquire are typically sold through private-label securitization through our Sequoia securitization program or to institutions that acquire pools of whole loans. Conforming loans we acquire are generally sold to Fannie Mae and Freddie Mac (the Agencies). Our residential loan acquisitions are usually made on a flow basis, after origination by banks or mortgage companies, and are periodically augmented by bulk acquisitions. Our acquisition and accumulation of residential loans is generally funded with equity and short-term debt. This segment also includes various derivative financial instruments and IO securities retained from our Sequoia securitizations that we utilize to manage certain risks associated with residential loans we acquire. Our residential mortgage banking segment s main source of revenue is mortgage banking income, which includes valuation increases (or gains) on the loans we acquire for sale or securitization as well as valuation changes in associated derivatives and IO securities that are used in part to manage risks associated with our mortgage banking activities. Additionally, this segment may generate interest income on loans held for future sale or securitization and interest income from IO securities. Interest expense on short-term debt used to fund the purchase of residential loans, direct operating expenses and tax provisions associated with these activities are also included in the residential mortgage banking segment.

Our residential investments segment includes a portfolio of investments in residential mortgage-backed securities retained from our Sequoia securitizations, as well as residential mortgage-backed securities issued by third parties. This segment also includes mortgage servicing rights (MSRs) associated with residential loans securitized through our Sequoia program or sold to third parties and MSRs purchased from third parties as well as residential loans acquired and held-for-investment. The residential investment segment s main sources of revenue are interest income from investment portfolio securities and residential loans held-for-investment, as well as the realized gains recognized upon sales of these securities and income from MSRs. This segment also includes derivative financial instruments that we utilize to manage certain risks associated with our residential investment portfolio. Also included in this segment is interest expense on the short-term debt and asset-backed securities (ABS) used to partially finance certain of these securities, as well as direct operating expenses and tax provisions associated with these activities.

Our commercial mortgage banking and investments segment consists of our commercial mortgage banking operations as well as our portfolio of held-for-investment commercial real estate loans. We operate as a commercial real estate lender by originating mortgage loans and providing other forms of commercial real estate financing. This may include senior or subordinate mortgage loans, mezzanine loans, and other forms of financing, such as preferred equity interests in special purpose entities that own commercial real estate. We typically sell the senior loans we originate to third parties for securitization and the mezzanine and subordinate loans we originate are generally held for investment. This segment also includes derivative financial instruments that we utilize to manage certain risks associated with our commercial loan origination activity. Our commercial mortgage banking and investments segment s main sources of revenue are interest income from our commercial loan investments as well as income from mortgage banking activities, which includes valuation increases (or gains) on the senior commercial loans we originate for sale as well as valuation changes in associated derivatives that are used to manage risks associated with our mortgage banking activities. Interest expense from a commercial securitization we engaged in during 2012 (Commercial Securitization) and from short-term and long-term debt used to fund the purchase of commercial loans as well as operating expenses and tax provisions associated with these activities are also included in the commercial mortgage banking and investments segment.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 1. Redwood Trust (continued)

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2014 and December 31, 2013, and for the three and nine months ended September 30, 2014 and 2013. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States of America as prescribed by the Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) and using the Securities and Exchange Commission s (SEC) instructions to Form 10-Q.

Organization

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Internal Revenue Code), beginning with its taxable year ended December 31, 1994. We generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as the REIT or our REIT. We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as our operating subsidiaries or our taxable REIT subsidiaries or TRS. Our mortgage banking activities and investments in MSRs are generally carried out through our taxable REIT subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our taxable REIT subsidiaries, and to distribute as dividends at least 90% of the taxable income we generate at our REIT.

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

Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during 2011 (Residential Resecuritization), and an entity formed in connection with a commercial securitization we engaged in during 2012 (Commercial Securitization). Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained in them, although we are also exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

For financial reporting purposes, the underlying loans and securities owned at the consolidated Sequoia entities, the Residential Resecuritization entity, and the Commercial Securitization entity are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The ABS issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned at these entities and interest expense on the ABS issued by these entities.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

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, amounts and timing of credit losses, prepayment rates, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported 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 mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;

- Indicative prices or yields from broker/dealers (including prices from counterparties under securities repurchase and whole-loan warehouse agreements); and, Other relevant observable inputs, including nonperformance risk and liquidity premiums.

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

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

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Fair Value Option

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

We elect the fair value option for certain residential and commercial loans, Sequoia IO securities, and MSRs. We generally elect the fair value option for residential and commercial loans that are held-for-sale, due to our intent to sell or securitize the loans in the near-term. We generally elect the fair value option for Sequoia IO securities as we use these in part to hedge certain risks associated with our residential loans held-for-sale. We elect the fair value option for our MSRs in order to reflect the current value of these investments in our financial position and results each period. We also elect the fair value option for certain secured borrowings we may recognize when the sale of commercial loans do not meet the sale criteria in ASC 860.

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

Real Estate Loans

Residential and Commercial Loans Held-for-Sale at Fair Value

Residential and commercial loans held-for-sale include loans that we are marketing for sale to third parties, including transfers to securitization entities that we plan to sponsor and expect to be accounted for as sales for financial reporting purposes. We generally elect the fair value option for residential and commercial loans that we purchase with the intent to sell to third parties or transfer to Sequoia securitizations. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

Residential and Commercial Loans Held-for-Investment

Residential Loans At Fair Value

Certain loans that were originally purchased with the intent to sell as part of our residential mortgage banking operations, and for which we elected the fair value option at acquisition, were subsequently reclassified to held-for-investment when the loans were pledged as collateral for borrowings made from the Federal Home Loan Bank of Chicago (FHLBC). As of September 30, 2014, our current intention is to hold these loans for longer-term investment while they are financed by the FHLBC. 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 other market valuation adjustments, net.

Commercial Loans At Fair Value

We may elect the fair value option for senior commercial mortgage loans that we originate or acquire that are bifurcated into a senior portion that is sold to a third party and a junior portion that we retain as an investment. When the transfer of the senior portion does not meet the criteria for sale treatment under GAAP, the entire loan (the senior and junior portions) remains on our consolidated balance sheet, and we account for the transfer of the senior portion as a secured borrowing liability. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Residential and Commercial Loans At Amortized Cost

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

We use the interest method to determine an effective yield to amortize the premium or discount on real estate loans held-for-investment. For residential loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine periodic amortization. For residential and commercial 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 or transferred to third parties. This may occur, for example, if we exercise our right to call ABS issued by a Sequoia securitization trust and decide to subsequently sell the underlying loans to third parties.

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

Residential Loans Allowance for Loan Losses

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

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

- Ongoing analyses of loans, including, but not limited to, the age of loans and year of origination, underwriting standards, business climate, economic conditions, and other observable data;
- Historical loss rates and past performance of similar loans;
- Relevant 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.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

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

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

Commercial Loans Allowance for Loan Losses

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

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

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

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

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

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

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

- Historical loss rates and past performance of similar loans in our own portfolio, if any;
- Publicly available third-party reference loss rates on similar loans; and,
- Trends in delinquencies and charge-offs in our own portfolio and among industry participants.

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

Repurchase Reserves

We sell residential mortgage loans to various parties, including (1) securitization trusts, (2) the Agencies, and (3) banks and other financial institutions that purchase mortgage loans. We also purchase mortgage servicing rights. We may be required to repurchase residential mortgage loans we have sold, or loans associated with MSRs we own, in the event of a breach of specified contractual representations and warranties made in connection with these sales and purchases. We do not originate residential mortgage loans and believe the initial risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans. However, in some cases, such as where loans were acquired from companies that have since become insolvent, we may be required to repurchase loans.

We establish reserves for mortgage repurchase liabilities related to various representations and warranties that reflect management s estimate of losses for loans for which we could have a repurchase obligation, based on a combination of factors. Such factors can include estimated future defaults and loan repurchase rates, the potential severity of loss in the event of defaults, and the probability of our being liable for a repurchase obligation. We establish a reserve at the time loans are sold and continually update our reserve estimate during its life. The reserve for mortgage loan repurchase losses is included in other liabilities on our consolidated balance sheets and the related expense is included as a component of mortgage banking activities, net on our consolidated statements of income.

We have originated and sold commercial mortgage loans and have made standard representations and warranties upon sale of the loans to the loan purchasers, and in some cases, to securitization trusts. We review the need for a repurchase reserve related to these commercial loans on an ongoing basis and are not aware of any breaches of representations and warranties related to these loans.

See *Note 15* for further discussion on the residential repurchase reserve.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Real Estate Securities, at Fair Value

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

Trading Securities

We primarily denote trading securities as those securities where we have adopted the fair value option. Trading securities are carried at their estimated fair values and coupon interest is recognized as interest income when earned and deemed collectible. Changes in the fair value of Sequoia IO and senior securities designated as trading securities are reported in mortgage banking activities, net, a component of our consolidated statements of income. Changes in the fair value of other trading securities are reported through our consolidated statements of income in other market valuation adjustments, net.

Available-for-Sale Securities

AFS securities primarily consist of non-agency residential mortgage backed securities (RMBS) and may include other residential and commercial securities. Non-Agency RMBS are not issued or guaranteed by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or any agency of the U.S. Government. AFS securities are carried at their estimated fair value with unrealized gains and losses excluded from earnings (except when an other-than-temporary impairment (OTTI) is recognized, as discussed below) and reported in accumulated other comprehensive income (AOCI), a component of stockholders equity.

Interest income on AFS securities is accrued based on their outstanding principal balance and contractual terms and interest income is recognized based on the security s effective interest rate. In order to calculate the effective interest rate, we must 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. On at least a quarterly basis, we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our own judgments about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield and interest income recognized on these securities or in the recognition of OTTI as discussed below.

For AFS securities purchased and held at a discount, a portion of the discount may be designated as non-accretable purchase discount (credit reserve), based on the cash flows we have projected for the security. The amount designated as credit reserve may be adjusted over time, based on our periodic evaluation of projected cash flows. If the performance of a security with a credit reserve is more favorable than previously forecasted, a portion of the credit reserve may be reallocated to accretable discount and recognized into interest income over time. Conversely, if the performance of a security with a credit reserve is less favorable than forecasted, the amount designated as credit reserve may be increased, or impairment charges and write-downs of such securities to a new cost basis could result.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

When the fair value of an AFS security is less than its amortized cost at the reporting date, the security is considered impaired. We assess our impaired securities at least quarterly to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). If we either (i) intend to sell the impaired security; (ii) will more likely than not be required to sell the impaired security before it recovers in value; or (iii) if there has been an adverse change in cash flows the impairment is deemed an OTTI. In the case of criteria (i) and (ii), we record the entire difference between the security s estimated fair value and its amortized cost at the reporting date in our consolidated statements of income. If there has been an adverse change in cash flows, only the portion of the OTTI related to credit losses is recognized through other market valuation adjustments, net on our consolidated statements of income, with the remaining non-credit portion recognized through AOCI on our consolidated balance sheet. If the first two criteria are not met and there has not been an adverse change in cash flows, the impairment is considered temporary and the entire unrealized loss is recognized through AOCI on our consolidated balance sheets.

For impaired AFS securities, to determine if there has been an adverse change in cash flows and if any portion of a resulting OTTI is related to credit losses, we compare the present value of the cash flows expected to be collected as of the current financial reporting date to the amortized cost basis of the security. The discount rate used to calculate the present value of expected future cash flows is the current yield used for income recognition purposes. If the present value of the current expected cash flows is less than the amortized cost basis, there has been an adverse change and the security is considered OTTI with the difference between these two amounts representing the credit loss. The determination as to whether an OTTI exists and, if so, the amount of credit impairment recognized in earnings is subjective, and based on information available at the time of the assessment as well as our estimates of future performance and cash flows. As a result, the timing and amount of OTTI constitute a material estimate that is susceptible to significant change.

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

MSRs

We recognize MSRs through the retention of servicing rights associated with residential mortgage loans that we have acquired and subsequently transferred to third parties (including the Agencies) or through the direct acquisition of MSRs sold by third parties. Typically, our MSRs are created through the transfer of loans to a third party or to a Sequoia residential mortgage securitization sponsored by us that meets the GAAP criteria for sale accounting.

Our MSRs are held and managed at Redwood Residential Acquisition Corporation, a wholly-owned subsidiary of RWT Holdings, Inc., which is a taxable REIT subsidiary of ours. We contract with a licensed sub-servicer to perform servicing functions for loans associated with our MSRs. We have elected the fair value option for all of our MSRs, and they are initially recognized and carried at their estimated fair values. Income from MSRs and changes in the estimated fair value of MSRs are reported in MSR income, net, a component of our consolidated statements of income.

See *Note 9* for further discussion on MSRs.

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less.

Restricted Cash

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities. Restricted cash may also include cash retained in the Sequoia securitization entities or in the Residential Resecuritization or Commercial Securitization entities prior to the payments on or redemptions of outstanding ABS issued.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Accrued Interest Receivable

Accrued interest receivable includes interest that is due and payable to us and deemed collectible. 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 receivable on these assets is measured at fair value. For financial assets where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Derivative Financial Instruments

Derivative financial instruments we typically utilize include swaps, swaptions, financial futures contracts, CMBX credit default index swaps, and To Be Announced (TBA) contracts. These derivatives are primarily used to manage interest rate risk associated with our operations. In addition, we enter into certain residential loan purchase commitments (LPCs) and residential loan forward sale commitments (FSCs) that are treated as derivatives for financial reporting purposes. All derivative financial instruments are recorded at their estimated fair values on our consolidated balance sheets. Derivatives with positive fair values to us are reported as assets and derivatives with negative fair values to us are reported as liabilities. We classify each derivative as either (i) a trading instrument (no specific hedging designation for financial reporting purposes) or (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

Changes in the fair values of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income through other market valuation adjustments, net, to the extent they are used to manage risks associated with our residential investment portfolio. Derivatives used to manage certain risks associated with our residential and commercial mortgage banking activities, including valuation changes related to residential LPCs and FSCs, are included in mortgage banking activities, net, on our consolidated statements of income.

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

We will discontinue a designated cash flow hedging relationship 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 or terminate a cash flow hedging relationship and the associated hedged item continues to exist, any unrealized gain or loss of the cash flow hedge at the time of de-designation remains in accumulated other comprehensive income and is amortized using the straight-line method through interest expense over the remaining life of the hedged item.

Swaps and Swaptions

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Eurodollar Futures and Financial Futures

Eurodollar futures are futures contracts on time deposits denominated in U.S. dollars at banks outside the United States. Eurodollar futures, unlike our other derivatives, have maturities of only three months. Therefore, in order to achieve the desired interest rate offset necessary to manage our risk, consecutively maturing contracts are required, resulting in a stated notional amount that is typically higher than our other derivatives. Financial futures are futures contracts on benchmark U.S. Treasury rates.

TBA Contracts

TBA contracts are forward contracts to purchase mortgage-backed securities that will be issued by a U.S. government sponsored enterprise in the future. We purchase or sell these derivatives to offset to varying degrees changes in the values of mortgage products for which we have exposure to interest rate volatility.

CMBX Credit Default Index Swaps

CMBX credit default index swaps are derivative instruments that reference an index reflecting the performance of specified tranches from selected commercial mortgage-backed securities (CMBS) transactions. Transacting in CMBX credit default index swaps enables us to hedge certain financial risks we are exposed to as we originate senior commercial mortgage loans in anticipation of the sale of these loans into CMBS transactions.

Loan Purchase and Forward Sale Commitments

We use the term LPCs to refer to agreements with third-party residential loan originators to purchase residential loans at a future date that qualify as a derivative under GAAP and we use the term FSCs to refer to agreements with third-parties to sell residential loans at a future date that also qualify as derivatives under GAAP. LPCs and FSCs are recorded at their estimated fair values on our consolidated balance sheets and changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

See *Note 10* for further discussion on derivative financial instruments.

Deferred Tax Assets and Liabilities

Our deferred tax assets/liabilities are generated by temporary differences in GAAP and taxable income at our taxable subsidiaries. These differences generally reflect differing accounting treatments for GAAP and tax, such as accounting for mortgage servicing rights, discount and premium amortization, credit losses, 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 as required and establish a deferred tax asset. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is reduced. We may also recognize income under GAAP in periods prior to when we recognize the income for tax. When this occurs, we establish a deferred tax liability. As the income is subsequently realized in future periods for tax, the deferred tax liability is reduced.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider historical and projected future taxable income and capital gains as well as tax planning strategies in making this assessment. We determine the extent to which realization of this deferred asset is not assured and establish a valuation allowance accordingly. The estimate of net deferred tax assets could change in future periods to the extent that actual or revised estimates of future taxable income during the carryforward periods change from current expectations.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Deferred Securities Issuance Costs

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

Other Assets

Other assets include margin and investment receivable, REO, income tax receivables, fixed assets, principal receivable, and other prepaid expenses and receivables.

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

See *Note 11* for further discussion on other assets.

Short-Term Debt

Short-term debt includes borrowings under master repurchase agreements, loan warehouse facilities, and other forms of borrowings that expire within one year with various counterparties. These borrowings may be unsecured or collateralized by cash, loans, or securities. If the value (as determined by the applicable counterparty) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the counterparty may retain the collateral and pursue any outstanding debt amount from us.

See *Note 12* 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, and is paid semi-annually for our convertible debt. 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

ABS issued represents asset-backed securities issued by bankruptcy-remote entities sponsored and consolidated by Redwood. These entities include certain Sequoia entities, the Residential Resecuritization, and the Commercial Securitization. Assets at these entities 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.

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

See *Note 13* for further discussion on ABS issued.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Long-Term Debt

FHLBC Borrowings

FHLBC borrowings include amounts borrowed, also referred to as advances, from the Federal Home Loan Bank of Chicago that are secured by eligible collateral, including, but not limited to, residential mortgage loans and residential mortgage-backed securities. FHLBC borrowings are carried at their unpaid principal balance and interest on advances is paid every 13 weeks from when each respective advance is made. If the value (as determined by the FHLBC) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the FHLBC may foreclose upon the collateral and pursue any outstanding debt amount from us. Individual advances can be made with maturities ranging from one day to 30 years.

Commercial Long-term Debt

Commercial long-term debt includes borrowings under a master repurchase agreement that, as of the date reported, expires in more than one year with a financial institution counterparty. Beginning in the third quarter of 2014, amounts previously classified as commercial long-term debt were reclassified to short-term debt due to the associated agreement expiring in less than one year as of September 30, 2014.

Commercial Secured Borrowings

Commercial secured borrowings represent liabilities recognized in association with cash received from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under ASC 860 and were accounted for as financings. We elect the fair value option for these secured borrowings and they are held at their estimated fair value on our consolidated balance sheets. These amounts do not represent legal obligations of Redwood and we are not required to make interest payments on these borrowings.

Convertible Notes

Convertible notes include unsecured convertible senior notes and are carried at their unpaid principal balance. Interest on the notes is payable semiannually and the notes mature on April 15, 2018. If converted by a holder, upon conversion the holder of the notes would receive shares of our common stock.

Trust Preferred Securities and Subordinated Notes

Trust preferred securities and subordinated notes are carried at their unpaid principal balance. This long-term debt is unsecured and interest is paid quarterly until it is redeemed in whole or matures at a future date.

See *Note 14* for further discussion on long-term debt.

Equity

Accumulated Other Comprehensive Income

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements designated as cash flow hedges are reported as components of accumulated other comprehensive income on our consolidated statements of changes in equity and our consolidated balance sheets. 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.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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 less income allocated to participating securities (as described herein). Diluted EPS is computed by dividing income allocated to common shareholders by the weighted average common shares outstanding plus amounts representing the dilutive effect of share-based payment awards. In addition, if the assumed conversion of convertible notes to common shares is dilutive, diluted EPS is adjusted by adding back the periodic interest expense associated with dilutive convertible debt to net income and adding the shares issued in an assumed conversion to the diluted share count.

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 between participating securities and common shares based on their respective rights to receive dividends or dividend equivalents. Accounting guidance on EPS defines vested and unvested share-based payment awards containing nonforfeitable rights to dividends or dividend equivalents as participating securities that are included in computing EPS under the two-class method.

See *Note 16* for further discussion on equity.

Incentive Plans

In May 2014, our shareholders approved the 2014 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors, which replaced the 2002 Redwood Trust, Inc. Incentive Plan. The Incentive Plan provides for the grant of restricted stock, deferred stock, deferred stock units, performance-based awards (including performance stock units), dividend equivalents, stock payments, restricted stock units, and other types of awards to eligible participants. Long-term incentive awards granted under the Incentive Plan generally vest over a three- or four-year period. Awards made under the Incentive Plan to officers and other employees in lieu of the payment in cash of a portion of annual bonuses earned generally vest immediately, but are subject to a three-year mandatory holding period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately. The cost of the awards is amortized over the vesting period on a straight-line basis.

Employee Stock Purchase Plan

In May 2013, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP) to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in the Company through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the last day of the calendar quarter.

Executive Deferred Compensation Plan

In November 2013, our Board of Directors approved an amendment to our 2002 Executive Deferred Compensation Plan (EDCP) to allow non-employee directors to defer certain cash payments and dividends into Deferred Stock Units (DSUs). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. The Company matches some deferrals. Compensation deferred under the EDCP is recorded as a liability on our consolidated balance sheets. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

401(k) Plan

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

See *Note 17* 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 record tax benefits only if tax positions meet a more-likely-than-not threshold in accordance with FASB guidance on accounting for uncertainty in income taxes. 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 20* for further discussion on taxes.

Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. ASU 2014-09 supersedes the revenue recognition requirements in Topic 605, Revenue Recognition and requires entities to recognize revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective retrospectively for annual or interim reporting periods beginning after December 15, 2016, with early application not permitted. We are currently evaluating the new standard.

Balance Sheet Netting

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at September 30, 2014 and December 31, 2013.

Offsetting of Financial Assets, Liabilities, and Collateral

September 30, 2014 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet [1] Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets [2]						
Interest rate agreements	$ 2,892	$ -	$ 2,892	$ (1,033)	$ (1,150)	$ 709
Credit default index swaps	2,372	-	2,372	-	(375)	1,997
TBAs	1,496	-	1,496	(1,484)	-	12
Total Assets	$ 6,760	$ -	$ 6,760	$ (2,517)	$ (1,525)	$ 2,718
Liabilities [2]						
Interest rate agreements	$ (34,449)	$ -	$ (34,449)	$ 1,033	$ 33,416	$ -
TBAs	(3,298)	-	(3,298)	1,484	1,267	(547)
Futures	(411)	-	(411)	-	411	-
Loan warehouse debt	(1,241,074)	-	(1,241,074)	1,241,074	-	-
Security repurchase agreements	(646,614)	-	(646,614)	646,614	-	-
Total Liabilities	$ (1,925,846)	$ -	$ (1,925,846)	$ 1,890,205	$ 35,094	$ (547)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

December 31, 2013 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet (1): Financial Instruments	Gross Amounts Not Offset in Consolidated Balance Sheet (1): Cash Collateral (Received) Pledged	Net Amount
Assets (2)						
Interest rate agreements	$ 6,566	$ -	$ 6,566	$ (5,402)	$ -	$ 1,164
TBAs	1,138	-	1,138	(656)	(482)	-
Total Assets	$ 7,704	$ -	$ 7,704	$ (6,058)	$ (482)	$ 1,164
Liabilities (2)						
Interest rate agreements	$ (16,599)	$ -	$ (16,599)	$ 5,402	$ 11,197	$ -
TBAs	(661)	-	(661)	656	5	-
Futures	(528)	-	(528)	-	528	-
Loan warehouse debt	(184,789)	-	(184,789)	184,789	-	-
Security repurchase agreements	(677,974)	-	(677,974)	677,974	-	-
Commercial borrowings	(49,467)	-	(49,467)	49,467	-	-
Total Liabilities	$ (930,018)	$ -	$ (930,018)	$ 918,288	$ 11,730	$ -

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

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation

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

Analysis of Consolidated VIEs

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

Assets and Liabilities of Consolidated VIEs at September 30, 2014

September 30, 2014 **(Dollars in Thousands)**	**Sequoia Entities**	**Residential Resecuritization**	**Commercial Securitization**	**Total**
Residential loans, held-for-investment	$ 1,546,507	$ -	$ -	$ 1,546,507
Commercial loans, held-for-investment	-	-	204,741	204,741
Real estate securities, at fair value	-	233,311	-	233,311
Restricted cash	147	-	138	285
Accrued interest receivable	1,882	506	1,527	3,915
Other assets	3,349	-	21,699	25,048
Total Assets	$ 1,551,885	$ 233,817	$ 228,105	$ 2,013,807
Accrued interest payable	$ 1,034	$ 7	$ 539	$ 1,580
Asset-backed securities issued	1,484,751	56,508	114,943	1,656,202
Total Liabilities	$ 1,485,785	$ 56,515	$ 115,482	$ 1,657,782

Number of VIEs	24	1	1	26

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation (continued)

We consolidate the assets and liabilities of the Commercial Securitization entity, as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity s inception and design. We transferred subordinate commercial loans to RCMC 2012-CREL1, a securitization entity. In connection with this transaction, we acquired certain subordinate securities that we continue to hold. We engaged in the Commercial Securitization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our commercial mezzanine loan portfolio. Our credit risk exposure is largely unchanged as a result of engaging in the transaction, as we remain economically exposed to the financed loans through our subordinate investment in the Commercial Securitization.

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 21 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSRs on our consolidated balance sheets, and classified those MSRs as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets.

The following table presents information related to securitization transactions that occurred during the three and nine months ended September 30, 2014 and 2013.

Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Principal balance of loans transferred	$ 635,608	$ 1,210,604	$ 982,913	$ 5,253,314
Trading securities retained, at fair value	1,680	8,702	71,243	100,552
AFS securities retained, at fair value	39,330	71,527	59,757	278,622
MSRs recognized	4,356	12,514	6,542	41,128

Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSRs (which we retain a third-party servicer to perform) and the receipt of interest income associated with the securities we retained. The following table summarizes the cash flows between us and the unconsolidated VIEs sponsored by us during the three and nine months ended September 30, 2014 and 2013.

Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2014**	**2013**	**2014**	**2013**
Cash proceeds	$ 610,167	$ 507,202	$ 877,943	$ 4,366,556
MSR fees received	3,571	3,160	10,618	6,235
Funding of compensating interest	(68)	(152)	(144)	(415)
Cash flows received on retained securities	16,190	15,656	44,417	30,606

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation (continued)

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

MSR Assumptions Related to Unconsolidated VIEs Sponsored by Redwood

	Issued During			
	Three Months Ended September 30,		Nine Months Ended September 30,	
At Date of Securitization	2014	2013	2014	2013
Prepayment speeds	5 - 16 %	5 - 8 %	5 - 16 %	5 - 13 %
Discount rates	11 %	12 %	11 %	12 %

The following table presents additional information at September 30, 2014 and December 31, 2013, related to unconsolidated securitizations accounted for as sales since 2012.

Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	September 30, 2014	December 31, 2013
On-balance sheet assets, at fair value:		
Interest-only and senior securities, classified as trading	$ 100,613	$ 110,505
Senior and subordinate securities, classified as AFS	441,835	405,415
Maximum loss exposure (1)	542,448	515,920
Assets transferred:		
Principal balance of loans outstanding	7,173,303	6,627,874
Principal balance of delinquent loans 30+ days delinquent	16,482	14,587

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation (continued)

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at September 30, 2014 and December 31, 2013.

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

September 30, 2014

(Dollars in Thousands)	MSRs	Senior Securities	Subordinate Securities
Fair value at June 30, 2014	$ 59,890	$ 100,613	$ 441,835
Expected life (in years) (1)	7	6	10
Prepayment speed assumption (annual CPR) (1)	12 %	9 %	10 %
Decrease in fair value from:			
10% adverse change	$ 2,454	$ 4,552	$ 404
25% adverse change	5,589	10,470	2,058
Discount rate assumption (1)	11 %	7 %	9 %
Decrease in fair value from:			
100 basis point increase	$ 2,381	$ 4,444	$ 33,310
200 basis point increase	4,568	8,528	62,862
Credit loss assumption (1)	N/A	0.25 %	0.25 %
Decrease in fair value from:			
10% higher losses	N/A	$ 144	$ 3,132
25% higher losses	N/A	349	7,779

December 31, 2013

(Dollars in Thousands)	MSRs	Senior Securities	Subordinate Securities

Fair value at December 31, 2013	$ 60,318	$ 110,505	$ 405,415
Expected life (in years) (1)	8	7	11
Prepayment speed assumption (annual CPR) (1)	8 %	10 %	11 %
Decrease in fair value from:			
10% adverse change	$ 1,649	$ 5,773	$ 1,658
25% adverse change	4,218	13,555	4,354
Discount rate assumption (1)	11 %	5 %	6 %
Decrease in fair value from:			
100 basis point increase	$ 2,468	$ 5,632	$ 30,644
200 basis point increase	4,828	10,757	57,836
Credit loss assumption (1)	N/A	0.23 %	0.23 %
Decrease in fair value from:			
10% higher losses	N/A	$ 70	$ 1,369
25% higher losses	N/A	175	3,420

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation (continued)

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at September 30, 2014, grouped by collateral type.

Third-Party Sponsored VIE Summary

(In Thousands)		**September 30, 2014**
Residential real estate securities at Redwood		
Senior	$	552,793
Re-REMIC		176,117
Subordinate		123,626
Total Investments in Third-Party Real Estate Securities	$	852,536

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

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

Other Transfers of Financial Assets

Certain of our senior commercial mortgage loans were bifurcated into a senior portion that was sold to a third party and a junior portion that we retained as an investment. When the transfer of the senior portion did not meet the criteria for sale treatment under GAAP, the entire loan (the senior and junior portions) remains on our consolidated balance sheet classified as a held-for-investment loan and we account for the transfer of the senior portion as a secured borrowing.

The following table presents commercial loan transfers accounted for as secured borrowings for the three and nine months ended September 30, 2014.

Loan Transfers Accounted for as Secured Borrowings

(In Thousands)	**Three Months Ended September 30, 2014**	**Nine Months Ended September 30, 2014**
Principal balance	$ -	$ 63,375
Cash proceeds	-	65,048

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments

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

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

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at September 30, 2014 and December 31, 2013.

	September 30, 2014		December 31, 2013	
(In Thousands)	**Carrying Value**	**Fair Value**	**Carrying Value**	**Fair Value**
Assets				
Residential loans, held-for-sale				
At fair value	$ 1,501,252	$ 1,501,252	$ 402,602	$ 402,602
At lower of cost or fair value	1,502	1,662	1,665	1,817
Residential loans, held-for-investment, at fair value	238,326	238,326	-	-
Residential loans, held-for-investment	1,546,507	1,447,463	1,762,167	1,610,024
Commercial loans, held-for-sale	175,421	175,421	89,111	89,111
Commercial loans, held-for-investment				
At fair value	70,712	70,712	-	-
At amortized cost	322,576	328,076	343,344	348,305
Trading securities	108,750	108,750	124,555	124,555
Available-for-sale securities	1,286,235	1,286,235	1,558,306	1,558,306

MSRs	135,152	135,152	64,824	64,824
Cash and cash equivalents	149,617	149,617	173,201	173,201
Restricted cash	455	455	398	398
Accrued interest receivable	15,261	15,261	13,475	13,475
Derivative assets	7,756	7,756	7,787	7,787
REO (1)	3,349	3,407	3,661	4,084
Margin receivable (1)	56,217	56,217	31,149	31,149
Other collateral posted (1)	5,000	5,000	5,000	5,000
Liabilities				
Short-term debt	$ 1,887,688	$ 1,887,688	$ 862,763	$ 862,763
Accrued interest payable	10,480	10,480	6,366	6,366
Derivative liabilities	38,263	38,263	18,167	18,167
ABS issued	1,656,202	1,548,795	1,942,962	1,746,906
FHLBC Borrowings	203,756	203,756	-	-
Commercial long-term debt	-	-	49,467	49,467
Commercial secured borrowings	66,146	66,146	-	-
Convertible notes	287,500	285,344	287,500	299,719
Other long-term debt	139,500	101,835	139,500	111,600

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

We elected the fair value option for $3.31 billion and $6.12 billion of residential loans (principal balance) and $340 million and $609 million of commercial loans (principal balance) we acquired during the three and nine months ended September 30, 2014, respectively. We also elected the fair value option for $65 million of commercial secured borrowings we recorded during the nine months ended September 30, 2014. We anticipate electing the fair value option for all future purchases of residential loans and commercial senior loans that we intend to sell to third parties or transfer to securitizations.

The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at September 30, 2014, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2014

September 30, 2014	Carrying	Fair Value Measurements Using		
(In Thousands)	Value	Level 1	Level 2	Level 3
Assets				
Residential loans, at fair value	$ 1,739,578	$ -	$ 399,145	$ 1,340,433
Commercial loans, at fair value	175,421	-	-	175,421
Trading securities	108,750	-	-	108,750
Available-for-sale securities	1,286,235	-	-	1,286,235
MSRs	135,152	-	-	135,152
Derivative assets	7,756	1,496	5,327	933
Liabilities				
Derivative liabilities	38,263	3,709	34,472	82
Commercial secured borrowings	66,146	-	-	66,146

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the nine months ended September 30, 2014.

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

	Assets						Liabilities
(In Thousands)	Residential Loans	Commercial Loans	Trading Securities	AFS Securities	MSRs	Derivatives [1]	Commercial Secured Borrowings
Beginning balance - December 31, 2013	$ 391,100	$ 89,111	$ 124,555	$ 1,558,306	$ 64,824	$ (379)	$ -
Principal paydowns	(20,728)	(3,684)	(5,848)	(138,751)	-	-	(1,081)
Discount accretion	-	-	-	32,774	-	-	-
Gains (losses) in net income, net	35,971	14,986	(15,041)	9,389	(5,944)	6,434	2,179
Unrealized gains in OCI, net	-	-	-	28,328	-	-	-
Acquisitions	3,557,753	611,624	66,253	192,151	76,272	-	65,048
Sales	(2,621,349)	(536,671)	(61,169)	(395,962)	-	-	-
Other settlements, net	(2,314)	55	-	-	-	(5,204)	-
Ending balance - September 30, 2014	$ 1,340,433	$ 175,421	$ 108,750	$ 1,286,235	$ 135,152	$ 851	$ 66,146

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at September 30, 2014 and 2013. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and nine months ended September 30, 2014 and 2013 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at September 30, 2014 and 2013 Included in Net Income

	Included in Net Income			
	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2014	2013	2014	2013
Assets				
Residential loans, at fair value	$ 7,280	$ (1,864)	$ 8,524	$ (3,088)
Commercial loans, at fair value	2,009	831	2,009	831
Trading securities	(1,882)	(1,525)	(16,033)	28,491
Available-for-sale securities	(188)	-	(434)	940
MSRs	3,509	1,344	(3,184)	12,561
Liabilities				
Loan purchase commitments	932	-	932	-
Commercial secured borrowing	(420)	-	1,339	-

The following table presents information on assets recorded at fair value on a non-recurring basis at September 30, 2014. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at September 30, 2014.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at September 30, 2014

					Gain (Loss) for	
September 30, 2014	Carrying	Fair Value Measurements Using			Three Months Ended	Nine Months Ended
(In Thousands)	Value	Level 1	Level 2	Level 3	September 30, 2014	September 30, 2014

Assets											
Residential loans, at lower of cost or fair value	$	1,106	$	-	$	-	$	1,106	$	1	$ (1)
REO		1,944		-		-		1,994		0	(133)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(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 nine months ended September 30, 2014 and 2013.

Market Valuation Adjustments, Net

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2014**	**2013**	**2014**	**2013**
Mortgage banking activities				
Residential loans, at fair value	$ 13,446	$ (10,804)	$ 34,554	$ (17,339)
Commercial loans, at fair value	4,305	3,171	13,644	2,826
Trading securities	(1,332)	(1,866)	(14,419)	36,399
Derivative instruments, net	(2,404)	442	(18,159)	51,009
Loan purchase and forward sale commitments	2,487	-	6,077	-
Total mortgage banking activites (1)	16,502	(9,057)	21,697	72,895
MSRs	2,321	460	(5,944)	9,628
Other				
Residential loans, at lower of cost or fair value	43	(11)	54	68
Held-for-investment loans at fair value	(991)	-	(991)	-
Trading securities	(577)	540	(653)	(4,168)
Impairments on AFS securities	(188)	-	(565)	(1,666)
REO	(361)	(76)	(825)	(407)
Other derivative instruments, net	(1,632)	9	(10,986)	74
Total other	(3,706)	462	(13,966)	(6,099)
Total Market Valuation Adjustments, Net	$ 15,117	$ (8,135)	$ 1,787	$ 76,425

(1) Income from mortgage banking activities presented above does not include fee income or provisions for repurchases that is a component of mortgage banking income presented on our consolidated statements of income as these amounts do not represent a market valuation adjustment.

Valuation Policy

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Valuation Process

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

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

Fair Value Methodology for Level 3 Financial Instruments

September 30, 2014

(Dollars in Thousands)	Fair Value	Unobservable Input	Range		Weighted Average	
Assets						
Residential loans, at fair value:						
Loans priced to securitization or priced to whole loan market and uncommitted to sell	$ 758,501	Discount rate	4 - 5	%	4	%
		Prepayment rate	8 - 8	%	8	%
		Default rate	1 - 1	%	1	%
		Loss severity	20 - 20	%	20	%
		Credit support	8 - 8	%	8	%
		Spread to securitization	38 - 38	bps	38	bps
		Credit spread	118 - 173	bps	129	bps
Loans priced to whole loan market, committed to sell	581,932	Pool fallout assumption	10 bps - 10 bps		10	bps
Residential loans, at lower of cost or fair value	1,106	Loss severity	15-28	%	21	%
Commercial loans, at fair value	175,421	Credit spread	152 bps - 152 bps		152	bps
		Credit support	24 - 24	%	24	%

Trading and AFS securities	1,394,985	Discount rate	4 - 12	%	6	%
		Prepayment speed	1 - 35	%	12	%
		Default rate	0 - 35	%	8	%
		Loss severity	20 - 64	%	35	%
		Credit support	0 - 88	%	6	%
MSRs	135,152	Discount rate	8 - 11	%	10	%
		Prepayment rate	4 - 60	%	10	%
REO	1,994	Loss severity	13 - 96	%	34	%
Loan purchase commitments, net (1)	851	MSR Multiple	1 - 5x		4x	
		Pullthrough rate	58 - 99	%	82	%
Liabilities						
Commercial secured financing	66,146	Credit spread	152 bps - 152 bps		152	bps
		Credit support	24 - 24	%	24	%

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Determination of Fair Value

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

Residential loans

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

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

Estimated fair values for conforming loans are determined based upon quoted market prices (Level 2). Conforming loans are mortgage loans that conform to Agency guidelines. As necessary, these values are adjusted for servicing value, market conditions and liquidity.

Commercial loans

Estimated fair values for senior commercial loans are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses include third-party Commercial Mortgage-Backed Securities (CMBS) sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for the securities for purchase into securitization (Level 2).

Estimated fair values for mezzanine commercial loans are determined by both market comparable pricing and discounted cash flow analysis valuation techniques (Level 3). Our discounted cash flow models utilize certain significant unobservable inputs including the underwritten net operating income and debt coverage ratio assumptions and actual performance relative to those underwritten metrics as well as estimated market discount rates. A decrease in these unobservable inputs will reduce the estimated fair value of the commercial loans.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Real estate securities

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

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at September 30, 2014, we received dealer price indications on 81% of our securities, representing 94% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were within 2% of the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Derivative assets and liabilities

Our derivative instruments include swaps, swaptions, TBAs, financial futures, CMBX credit default index swaps, LPCs, and FSCs. Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets. TBA and financial futures fair values are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2). CMBX credit default index swaps are generally obtained using quoted prices; however, they are not always actively traded (Level 2). LPC fair values are estimated based on quoted Agency MBS prices, estimates of the fair value of the MSRs we expect to retain in the sale of the loans, and the probability that the mortgage loan will be purchased (Level 3). FSC fair values are obtained using quoted Agency prices. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2).

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

MSRs

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

As part of our MSR valuation process, we received a valuation estimate from a third-party valuations group. In the aggregate, our internal valuation of the MSRs was less than 1% lower than the third-party valuation at September 30, 2014.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

REO

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

Margin receivable

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

Short-term debt

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

ABS issued

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

As part of our ABS issued valuation process, we also request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at September 30, 2014, we received dealer price indications on 42% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were within 1% of the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

FHLBC Borrowings

FHLBC borrowings include amounts borrowed from the Federal Home Loan Bank of Chicago that are secured by residential mortgage loans or residential mortgage-backed securities. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 1).

Commercial secured borrowings

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

Convertible notes

Convertible notes include unsecured convertible senior notes. Fair values are determined using quoted prices in active markets (Level 1).

Trust preferred securities and subordinated notes

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

Note 6. Residential Loans

We acquire residential loans from third-party originators. The following table summarizes the classifications and carrying value of the residential loans owned at Redwood and at consolidated Sequoia Entities at September 30, 2014 and December 31, 2013.

September 30, 2014

(In Thousands)	**Redwood**	**Sequoia**	**Total**
Held-for-sale			
Fair value - Conforming	$ 399,145	$ -	$ 399,145
Fair value - Jumbo	1,101,782	-	1,101,782
Lower of cost or fair value	1,502	-	1,502
Held-for-investment			
Fair value - Jumbo	238,651	-	238,651
At amortized cost	-	1,546,507	1,546,507
Total Residential Loans	$ 1,741,080	$ 1,546,507	$ 3,287,587

December 31, 2013

(In Thousands)	**Redwood**	**Sequoia**	**Total**
Held-for-sale			
Fair value - Conforming	$ 11,502	$ -	$ 11,502
Fair value - Jumbo	391,100	-	391,100
Lower of cost or fair value	1,665	-	1,665
Held-for-investment, at amortized cost	-	1,762,167	1,762,167
Total Residential Loans	$ 404,267	$ 1,762,167	$ 2,166,434

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 6. Residential Loans (continued)

As of September 30, 2014, we owned mortgage servicing rights associated with $1.61 billion of consolidated residential loans purchased form third-party originators. The value of these MSRs is included in the carrying value of the associated loans on our balance sheet. We contract with a licensed sub-servicer that performs servicing functions for these loans.

Residential Loans Held-for-Sale

Residential Loans at Fair Value

At September 30, 2014, we held 2,862 residential loans at fair value, with an aggregate outstanding principal balance of $1.46 billion and an aggregate fair value of $1.50 billion. During the three and nine months ended September 30, 2014, we purchased $3.31 billion and $6.12 billion (principal balance) of residential loans, respectively, for which we elected the fair value option. During the three and nine months ended September 30, 2014, we recorded $13 million and $35 million of positive valuation adjustments, respectively, on fair value residential loans through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2013, we held 537 residential loans at fair value, with an aggregate outstanding principal balance of $399 million and an aggregate fair value of $403 million.

Residential Loans at Lower of Cost or Fair Value

At September 30, 2014, we held nine residential loans at lower of cost or fair value with $2 million in outstanding principal balance and a carrying value of $2 million. At December 31, 2013, we held 10 residential loans at lower of cost or fair value with $2 million in outstanding principal balance and a carrying value of $2 million. During the three and nine months ended September 30, 2014, we recorded valuation adjustments for residential loans held-for-sale of positive $43 thousand and $54 thousand, respectively.

Residential Loans Held-for-Investment

Residential Loans at Fair Value

During the three months ended September 30, 2014, we transferred loans with a principal balance of $235 million and a fair value of $241 million from held-for-sale at fair value to held-for-investment at fair value. As of September 30, 2014, these loans were pledged as collateral under the FHLBC borrowing agreement and our current intention is to hold these loans for investment.

Residential Loans at Amortized Cost

The following table details the carrying value for residential loans held-for-investment at amortized cost at September 30, 2014 and December 31, 2013. These loans are owned at Sequoia securitization entities that we consolidate for financial reporting purposes.

(In Thousands)	**September 30, 2014**	**December 31, 2013**
Principal balance	$ 1,554,876	$ 1,770,803
Unamortized premium, net	13,540	16,791
Recorded investment	1,568,416	1,787,594
Allowance for loan losses	(21,909)	(25,427)
Carrying Value	$ 1,546,507	$ 1,762,167

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 6. Residential Loans (continued)

Of the $1.55 billion of principal balance and $14 million of unamortized premium on loans held-for-investment at September 30, 2014, $629 million of principal balance and $8 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the nine months ended September 30, 2014, 14% of these residential loans prepaid and we amortized 23% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal balance was $929 million and the unamortized premium was $5 million. During the nine months ended September 30, 2014, 11% of these loans prepaid and we amortized 13% of the premium.

Of the $1.77 billion of principal balance and $17 million of unamortized premium on loans held-for-investment at December 31, 2013, $731 million of principal balance and $11 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal balance was $1 billion and the unamortized premium was $6 million.

Credit Characteristics of Residential Loans Held-for-Investment

As a percentage of our recorded investment, 99% of residential loans held-for-investment at September 30, 2014, were first lien, predominately prime-quality loans at the time of origination. The remaining 1% of loans were second lien, home equity lines of credit. The weighted average original LTV ratio for our residential loans held-for-investment outstanding at September 30, 2014, was 66%. The weighted average FICO score for the borrowers of these loans was 733 at the time the loans were originated.

We consider the year of origination of our residential loans held-for-investment to be a general indicator of credit performance as loans originated in specific years have often possessed similar product and credit characteristics. The following table displays our recorded investment in residential loans held-for-investment at September 30, 2014 and December 31, 2013, organized by year of origination.

(In Thousands)	**September 30, 2014**	**December 31, 2013**
2003 & Earlier	$ 758,768	$ 881,364
2004	459,050	513,458
2005	59,946	62,675
2006	138,263	149,776
2007	-	-

2008		-		-
2009		19,273		25,860
2010		80,209		92,728
2011		52,907		61,733
Total Recorded Investment	$	1,568,416	$	1,787,594

Allowance for Loan Losses on Residential Loans

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 6. Residential Loans (continued)

Activity in the Allowance for Loan Losses on Residential Loans

The following table summarizes the activity in the allowance for loan losses for the three and nine months ended September 30, 2014 and 2013.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2014**	**2013**	**2014**	**2013**
Balance at beginning of period	$ 23,972	$ 23,150	$ 25,427	$ 28,504
Charge-offs, net	(1,355)	(818)	(2,833)	(3,363)
(Reversal of provision) provision for loan losses	(708)	883	(685)	(1,926)
Balance at End of Period	$ 21,909	$ 23,215	$ 21,909	$ 23,215

During each of the three months ended September 30, 2014 and 2013, there were $1 million of charge-offs of residential loans that reduced our allowance for loan losses. These charge-offs were from $6 million and $3 million of defaulted loan principal, respectively. During each of the nine months ended September 30, 2014 and 2013, there were $3 million of charge-offs of residential loans that reduced our allowance for loan losses. These charge-offs arose from $14 million and $10 million of defaulted loan principal, respectively.

Residential Loans Collectively Evaluated for Impairment

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

The following table summarizes the balances for loans collectively evaluated for impairment at September 30, 2014 and December 31, 2013.

(In Thousands)	September 30, 2014	December 31, 2013
Principal balance	$ 1,539,330	$ 1,762,165
Recorded investment	1,553,147	1,779,161
Related allowance	20,580	24,762

The following table summarizes the recorded investment and past due status of residential loans collectively evaluated for impairment at September 30, 2014 and December 31, 2013.

(In Thousands)	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Current	Total Loans
September 30, 2014	$ 25,885	$ 10,046	$ 73,355	$ 1,443,861	$ 1,553,147
December 31, 2013	34,187	13,248	79,010	1,652,716	1,779,161

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 6. Residential Loans (continued)

Residential Loans Individually Evaluated for Impairment

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for qualifying borrowers and potentially reduce a future impairment. For the nine months ended September 30, 2014 and 2013, all of the loan modifications determined to be TDRs were either: (i) conversions of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reductions in the contractual interest rates of a mortgage loan paired with capitalization of accrued interest; or (iii) principal forgiveness paired with interest rate reductions.

The following table presents the details of the loan modifications determined to be TDRs for the three and nine months ended September 30, 2014 and 2013.

(Dollars in Thousands)	Three Months Ended September 30, 2014	2013	Nine Months Ended September 30, 2014	2013
TDRs				
Number of modifications	8	5	22	12
Pre-modification outstanding recorded investment	$ 2,041	$ 1,144	$ 7,008	$ 2,939
Post-modification outstanding recorded investment	2,081	898	7,245	2,838
Loan modification effect on net interest income after provision and other MVA	(494)	(555)	(1,714)	(863)
TDRs that Subsequently Defaulted				
Number of modifications	3	1	9	4
Recorded investment	$ 672	$ 201	$ 3,165	$ 788

If we determine that a restructured loan is a TDR, we remove it from the general loan pools used for determining the allowance for residential loan losses and assess it for impairment on an individual basis. This assessment is based primarily on whether an adverse change in the expected future cash flows resulted from the restructuring. The average recorded investment of loans for the three months ended September 30, 2014 and 2013 was $15 million and $8 million, respectively. The average recorded investment of loans individually evaluated for impairment for the nine months ended September 30, 2014 and 2013 was $12 million and $7 million, respectively. For the three months ended September 30, 2014 and 2013, we recorded interest income of $32 thousand and $81 thousand, respectively, on individually impaired loans. For the nine months ended September 30, 2014 and 2013, we recorded interest income of $99 thousand and $102 thousand, respectively, on individually impaired loans.

The following table summarizes the balances for loans individually evaluated for impairment, all of which had an allowance, at September 30, 2014 and December 31, 2013.

(In Thousands)	**September 30, 2014**	**December 31, 2013**
Principal balance	$ 15,546	$ 8,638
Recorded investment	15,269	8,433
Related allowance	1,329	665

The following table summarizes the recorded investment and past due status of residential loans individually evaluated for impairment at September 30, 2014 and December 31, 2013.

(In Thousands)	**30-59 Days Past Due**	**60-89 Days Past Due**	**90+ Days Past Due**	**Current**	**Total Loans**
September 30, 2014	$ 1,842	$ 1,538	$ 544	$ 11,345	$ 15,269
December 31, 2013	1,560	-	567	6,306	8,433

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 7. Commercial Loans

We invest in commercial loans that we originate and service as well as loans that we acquire from third-party originators. The following table summarizes the classifications and carrying value of commercial loans at September 30, 2014 and December 31, 2013.

(In Thousands)	**September 30, 2014**		**December 31, 2013**	
Held-for-sale, at fair value	$	104,709	$	89,111
Held-for-investment				
At fair value		70,712		-
At amortized cost		322,576		343,344
Total Commercial Loans	$	497,997	$	432,455

Of the held-for-investment commercial loans at amortized cost shown above at September 30, 2014 and December 31, 2013, $205 million and $258 million, respectively, were financed through the Commercial Securitization entity, as discussed in *Note 4*.

Commercial Loans Held-for-Sale

Commercial loans held-for-sale include loans we originate and intend to sell to third parties. At September 30, 2014, we held seven commercial loans at fair value, with an aggregate outstanding principal balance of $103 million and an aggregate fair value of $105 million. During the three and nine months ended September 30, 2014, we originated and funded senior commercial loans for $340 million and $578 million, respectively, and recorded $4 million and $14 million, respectively, of positive valuation adjustments on commercial loans held-for-sale through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2013, we held seven senior commercial loans at fair value, with an aggregate outstanding principal balance of $88 million and an aggregate fair value of $89 million.

Commercial Loans Held-for-Investment

Commercial Loans Held-for-Investment, at Fair Value

Commercial loans held-for-investment at fair value include certain loans we hold for investment for which we have elected the fair value option. At September 30, 2014, we held three of these commercial loans, with an aggregate outstanding principal balance of $68 million and an aggregate fair value of $71 million. During the three months ended September 30, 2014, we did not originate any commercial loans held-for-investment at fair value and recorded $420 thousand of negative valuation adjustments on our existing portfolio. During the nine months ended September 30, 2014, we originated and funded commercial loans for $31 million and recorded $2 million of positive valuation adjustments on commercial loans held-for-investment at fair value through mortgage banking activities, net, a component of our consolidated income statement. We did not have any commercial loans held-for-investment at fair value at December 31, 2013.

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September 30, 2014

(Unaudited)

Note 7. Commercial Loans (continued)

Commercial Loans Held-for-Investment, at Amortized Cost

Commercial loans held-for-investment at amortized cost include loans we originate and preferred equity investments we make or, in either case, acquire from third parties. Through September 30, 2014, these loans have typically been mezzanine loans that are secured by a borrower s ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. The preferred equity investments are typically preferred equity interests in a single purpose entity that owns commercial property and are included within, and referred to herein, as commercial loans held-for-investment due to the fact that their risks and payment characteristics are nearly equivalent to commercial mezzanine loans.

The following table provides additional information for our commercial loans held-for-investment at amortized cost at September 30, 2014 and December 31, 2013.

(In Thousands)	**September 30, 2014**	**December 31, 2013**
Principal balance	$ 332,258	$ 353,331
Unamortized discount, net	(2,253)	(2,614)
Recorded investment	330,005	350,717
Allowance for loan losses	(7,429)	(7,373)
Carrying Value	$ 322,576	$ 343,344

At September 30, 2014, we held 55 commercial loans held-for-investment at amortized cost with an outstanding principal balance of $332 million and a carrying value of $323 million. During the three and nine months ended September 30, 2014, we originated or acquired $26 million and $34 million, respectively, of commercial loans held-for-investment at amortized cost. Of the $330 million of recorded investment in commercial loans held-for-investment at September 30, 2014, 10% was originated in 2014, 20% was originated in 2013, 37% was originated in 2012, 29% was originated in 2011, and 4% was originated in 2010.

At December 31, 2013, we held 50 commercial loans held-for-investment at amortized cost with an outstanding principal balance of $353 million and a carrying value of $343 million. Of the $351 million of recorded investment in commercial loans held-for-investment at December 31, 2013, 19% was originated in 2013, 43% was originated in

2012, 34% was originated in 2011, and 4% was originated in 2010.

Allowance for Loan Losses on Commercial Loans

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

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

(In Thousands)	**September 30, 2014**	**December 31, 2013**
Pass	$ 306,575	$ 309,792
Watch list	25,683	43,539
Total Commercial Loans Held-for-Investment	$ 332,258	$ 353,331

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2014

(Unaudited)

Note 7. Commercial Loans (continued)

Activity in the Allowance for Loan Losses on Commercial Loans

The following table summarizes the activity in the allowance for commercial loan losses for the three and nine months ended September 30, 2014 and 2013.

(In Thousands)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Balance at beginning of period	$ 8,317	$ 5,660	$ 7,373	$ 4,084
Charge-offs, net	-	-	-	-
Reversal of provision (provision) for loan losses	(888)	844	56	2,420
Balance at End of Period	$ 7,429	$ 6,504	$ 7,429	$ 6,504

Commercial Loans Collectively Evaluated for Impairment

At September 30, 2014 and December 31, 2013, all of our commercial loans collectively evaluated for impairment were current. The following table summarizes the balances for loans collectively evaluated for impairment at September 30, 2014 and December 31, 2013.

(In Thousands)	September 30, 2014	December 31, 2013
Principal balance	$ 332,258	$ 353,331
Recorded investment	330,005	350,717
Related allowance	7,429	7,373

Commercial Loans Individually Evaluated for Impairment

We did not have any commercial loans individually evaluated for impairment at either September 30, 2014 or December 31, 2013.

Note 8. Real Estate Securities

We invest in residential mortgage-backed securities. The following table presents the fair values of our real estate securities by type at September 30, 2014 and December 31, 2013.

(In Thousands)	**September 30, 2014**	**December 31, 2013**
Trading	$ 108,750	$ 124,555
Available-for-sale	1,286,235	1,558,306
Total Real Estate Securities	$ 1,394,985	$ 1,682,861

Our real estate securities herein are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior 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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 8. Real Estate Securities (continued)

Trading Securities

We elected the fair value option for certain securities and classify them as trading securities. At September 30, 2014, our trading securities included $105 million of interest-only securities, for which there is no principal balance, $3 million of senior securities and less than $1 million of residential subordinate securities. The unpaid principal balance of residential senior and subordinate securities classified as trading was $3 million and $11 million, respectively, at September 30, 2014. The following table presents trading securities by collateral type at September 30, 2014 and December 31, 2013.

(In Thousands)	**September 30, 2014**	**December 31, 2013**
Senior Securities		
Prime	$ 100,612	$ 110,505
Non-prime	7,758	9,070
Total Senior Securities	108,370	119,575
Subordinate Securities		
Prime	380	4,980
Total Subordinate Securities	380	4,980
Total Trading Securities	$ 108,750	$ 124,555

AFS Securities

The following table presents the fair value of our available-for-sale securities held at Redwood by collateral type at September 30, 2014 and December 31, 2013.

(In Thousands)	**September 30, 2014**	**December 31, 2013**

Senior Securities				
Prime	$	358,813	$	662,306
Non-prime		186,223		193,386
Total Senior Securities		545,036		855,692
Re-REMIC Securities		176,117		176,376
Subordinate Securities				
Prime		564,932		526,095
Non-prime		150		143
Total Subordinate Securities		565,082		526,238
Total AFS Securities	$	1,286,235	$	1,558,306

The senior securities shown above at September 30, 2014 and December 31, 2013, included $111 million and $131 million, respectively, of prime securities, and $122 million and $132 million, respectively, of non-prime securities that were financed through the Residential Resecuritization entity, as discussed in *Note 4*.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2014

(Unaudited)

Note 8. Real Estate Securities (continued)

At September 30, 2014, there were $9 million of AFS residential securities with contractual maturities less than five years, $2 million of AFS residential securities with contractual maturities greater than five years but less than 10 years, and the remainder of our real estate securities had contractual maturities greater than 10 years.

The following table presents the components of carrying value (which equals fair value) of residential AFS securities at September 30, 2014 and December 31, 2013.

Carrying Value of Residential AFS Securities

September 30, 2014	**Senior**				
(In Thousands)	**Prime**	**Non-prime**	**Re-REMIC**	**Subordinate**	**Total**
Principal balance	$ 362,902	$ 202,812	$ 206,212	$ 694,308	$ 1,466,234
Credit reserve	(4,082)	(9,894)	(16,553)	(43,346)	(73,875)
Unamortized discount, net	(41,314)	(33,676)	(80,986)	(143,129)	(299,105)
Amortized cost	317,506	159,242	108,673	507,833	1,093,254
Gross unrealized gains	42,113	27,004	67,444	59,427	195,988
Gross unrealized losses	(805)	(24)	-	(2,178)	(3,007)
Carrying Value	$ 358,814	$ 186,222	$ 176,117	$ 565,082	$ 1,286,235

December 31, 2013	**Senior**				
(In Thousands)	**Prime**	**Non-prime**	**Re-REMIC**	**Subordinate**	**Total**
Principal balance	$ 670,051	$ 218,603	$ 214,046	$ 706,292	$ 1,808,992
Credit reserve	(10,144)	(13,840)	(30,429)	(62,457)	(116,870)
Unamortized discount, net	(44,133)	(36,882)	(80,188)	(137,266)	(298,469)
Amortized cost	615,774	167,881	103,429	506,569	1,393,653
Gross unrealized gains	47,980	25,654	72,947	41,205	187,786
Gross unrealized losses	(1,448)	(149)	-	(21,536)	(23,133)

Carrying Value	$ 662,306	$ 193,386	$ 176,376	$ 526,238	$ 1,558,306

The following table presents the changes for the three and nine months ended September 30, 2014, in unamortized discount and designated credit reserves on residential AFS securities.

Changes in Unamortized Discount and Designated Credit Reserves on Residential AFS Securities

	Three Months Ended September 30, 2014	
(In Thousands)	**Credit Reserve**	**Unamortized Discount, Net**
Beginning balance	$ 83,276	$ 304,293
Amortization of net discount	-	(10,890)
Realized credit losses	(1,692)	-
Acquisitions	1,589	4,404
Sales, calls, other	(1,013)	(7,175)
Impairments	188	-
Transfers to (release of) credit reserves, net	(8,473)	8,473
Ending Balance	$ 73,875	$ 299,105

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2014

(Unaudited)

Note 8. Real Estate Securities (continued)

(In Thousands)	Nine Months Ended September 30, 2014 Credit Reserve	Unamortized Discount, Net
Beginning balance	$ 116,870	$ 298,469
Amortization of net discount	-	(32,774)
Realized credit losses	(9,002)	-
Acquisitions	1,846	7,241
Sales, calls, other	(2,425)	(7,810)
Impairments	565	-
Transfers to (release of) credit reserves, net	(33,979)	33,979
Ending Balance	$ 73,875	$ 299,105

Residential AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at September 30, 2014 and December 31, 2013.

	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
(In Thousands)	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
September 30, 2014	$ 104,118	$ (1,097)	$ 103,021	$ 75,582	$ (1,910)	$ 73,672
December 31, 2013	607,030	(21,195)	585,835	19,828	(1,938)	17,890

At September 30, 2014, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 294 AFS securities, of which 30 were in an unrealized loss position and 12 were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2013, our consolidated balance sheet included 303 AFS securities, of which 76 were in an unrealized loss position and five were in a continuous unrealized loss position for 12 consecutive months or longer.

Evaluating AFS Securities for Other-than-Temporary Impairments

Gross unrealized losses on our AFS securities were $3 million at September 30, 2014. We evaluate all securities in an unrealized loss position to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). At September 30, 2014, we did not intend to sell any of our AFS securities that were in an unrealized loss position, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity. We review our AFS securities that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent security performance and expected future performance of the underlying collateral.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 8. Real Estate Securities (continued)

During the three months ended September 30, 2014, we determined that unrealized losses of less than $1 million related to our AFS securities were OTTI, of which less than $1 million was determined to be credit related and recorded in Other market valuation adjustments in our consolidated statements of income and none was determined to be non-credit related and recorded through AOCI on our consolidated balance sheets. AFS securities on which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. In determining our estimate of cash flows for AFS securities we may consider factors such as structural credit enhancement, past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, which are informed by prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, and geographic concentrations, as well as general market assessments. Changes in our evaluation of these factors impacted the cash flows expected to be collected at the OTTI assessment date and were used to determine if there were credit-related adverse cash flows and if so, the amount of credit related losses. Significant judgment is used in both our analysis of the expected cash flows for our AFS securities and any determination of the credit loss component of OTTI.

The table below summarizes the significant valuation assumptions we used for our OTTI AFS securities at September 30, 2014.

Significant Valuation Assumptions

	Range for Securities	
September 30, 2014	**Prime Securities**	**Non-prime**
Prepayment rates	15 - 20 %	10 - 10 %
Loss severity	20 - 52 %	35 - 35 %
Projected default rate	1 - 22 %	15 - 15 %

The following table details the activity related to the credit loss component of OTTI (i.e., OTTI recognized through earnings) for AFS securities held at September 30, 2014 and 2013, for which a portion of an OTTI was recognized in other comprehensive income.

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

(In Thousands)	Three Months Ended September 30, 2014	2013	Nine Months Ended September 30, 2014	2013
Balance at beginning of period	$ 34,256	$ 42,674	$ 37,149	$ 50,852
Additions				
Initial credit impairments	-	-	261	-
Subsequent credit impairments	-	-	70	-
Reductions				
Securities sold, or expected to sell	(18)	(3,288)	(922)	(5,479)
Securities with no outstanding principal at period end	-	(764)	(2,320)	(6,751)
Balance at End of Period	$ 34,238	$ 38,622	$ 34,238	$ 38,622

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September 30, 2014

(Unaudited)

Note 8. Real Estate Securities (continued)

Gross Realized Gains and Losses on AFS Securities

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains and losses on sales and calls of AFS securities for the three and nine months ended September 30, 2014 and 2013.

(In Thousands)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Gross realized gains - sales	$ 10,227	$ 10,532	$ 11,219	$ 22,762
Gross realized gains - calls	462	-	1,449	333
Gross realized losses - sales	(2,713)	(214)	(2,713)	(214)
Gross realized losses - calls	-	-	-	-
Total Realized Gains on Sales and Calls of AFS Securities, net	$ 7,976	$ 10,318	$ 9,955	$ 22,881

Note 9. Mortgage Servicing Rights

We invest in mortgage servicing rights associated with residential mortgage loans and contract with a licensed sub-servicer to perform all servicing functions for these loans. The following table presents the fair value of MSRs and the aggregate principal amounts of associated loans as of September 30, 2014 and December 31, 2013.

	September 30, 2014		December 31, 2013	
(In Thousands)	MSR Fair Value	Associated Principal	MSR Fair Value	Associated Principal
Mortgage Servicing Rights				
Conforming Loans	$ 73,953	$ 6,254,058	$ 3,331	$ 308,258
Jumbo Loans	61,199	5,962,758	61,493	5,483,500
Total Mortgage Servicing Rights	$ 135,152	$ 12,216,816	$ 64,824	$ 5,791,758

The following table presents activity for MSRs for the three and nine months ended September 30, 2014 and 2013.

MSR Activity

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2014**	**2013**	**2014**	**2013**
Balance at beginning of period	$ 71,225	$ 43,098	$ 64,824	$ 5,315
Additions	61,606	16,676	76,272	45,291
Changes in fair value due to:				
Changes in assumptions (1)	4,323	1,444	(318)	11,764
Other changes (2)	(2,002)	(984)	(5,626)	(2,136)
Balance at End of Period	$ 135,152	$ 60,234	$ 135,152	$ 60,234

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 9. Mortgage Servicing Rights (continued)

We make investments in MSRs through the retention of servicing rights associated with the residential mortgage loans that we have acquired and subsequently transfer to third parties or through the direct acquisition of MSRs sold by third parties. The following table details the retention and purchase of MSRs during the three and nine months ended September 30, 2014.

MSR Additions

(In Thousands)	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	MSR Fair Value	Associated Principal	MSR Fair Value	Associated Principal
Jumbo MSR additions:				
From securitization	$ 4,356	$ 516,004	$ 6,542	$ 773,205
From loan sales	-	-	488	58,793
Total jumbo MSR additions	4,356	516,004	7,030	831,998
Conforming MSR additions:				
From loan sales	$ 14,630	$ 1,352,122	$ 23,933	$ 2,232,559
From purchases	42,620	3,497,224	45,309	3,770,566
Total conforming MSR additions	57,250	4,849,346	69,242	6,003,125
Total MSR additions	$ 61,606	$ 5,365,350	$ 76,272	$ 6,835,123

MSR Income

The following table presents the components of our MSR income.

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013

Servicing income, net:				
Income	$ 4,590	$ 3,008	$ 12,287	$ 5,820
Cost of sub-servicer	(437)	(355)	(1,040)	(767)
Net servicing income	4,153	2,653	11,247	5,053
Market valuation adjustments	2,321	460	(5,944)	9,628
MSR provision for repurchases	(653)	-	(653)	-
Income from MSRs, Net	$ 5,821	$ 3,113	$ 4,650	$ 14,681

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Note 10. Derivative Financial Instruments

The following table presents the fair value and notional amount of derivative financial instruments held by us at September 30, 2014 and December 31, 2013.

	September 30, 2014		December 31, 2013	
(In Thousands)	**Fair Value**	**Notional Amount**	**Fair Value**	**Notional Amount**
Assets - Risk Management Derivatives				
Interest rate swaps	$ 148	$ 60,500	$ 5,972	$ 268,000
TBAs	1,496	671,000	1,138	241,000
Swaptions	2,744	420,000	596	340,000
Credit default index swaps	2,372	75,000	-	-
Assets - Other Derivatives				
Loan purchase commitments	933	273,781	-	360
Loan forward sale commitments	63	128,232	81	10,000
Total Assets	$ 7,756	$ 1,628,513	$ 7,787	$ 859,360
Liabilities - Cash Flow Hedges				
Interest rate swaps	$ (33,973)	$ 139,500	$ (16,519)	$ 139,500
Liabilities - Risk Management Derivatives				
Interest rate swaps	(476)	154,500	(80)	50,500
TBAs	(3,298)	1,274,500	(661)	235,000
Futures	(411)	108,000	(528)	162,000
Liabilities - Other Derivatives				
Loan purchase commitments	(82)	50,439	(379)	42,562
Loan forward sale commitments	(23)	200,000	-	-
Total Liabilities	$ (38,263)	$ 1,926,939	$ (18,167)	$ 629,562
Total Derivative Financial Instruments, Net	$ (30,507)	$ 3,555,452	$ (10,380)	$ 1,488,922

Risk Management Derivatives

To manage, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheet, we may enter into derivative contracts. In order to manage certain risks associated with residential loans, residential securities, and commercial loans we own or plan to acquire, at September 30, 2014, we were party to swaps and swaptions with an aggregate notional amount of $635 million, TBA contracts sold with an aggregate notional amount of $1.9 billion, credit default index swaps with an aggregated notional amount of $75 million, and financial futures contracts with an aggregate notional amount of $108 million. Net market valuation adjustments on risk management derivatives were negative $4 million and negative $29 million for the three and nine months ended September 30, 2014, respectively, and positive less than $1 million and $51 million for the three and nine months ended September 30, 2013, respectively.

Loan Purchase and Forward Sale Commitments

LPCs and FSCs that qualify as derivatives are recorded at their estimated fair values. Net valuation adjustments on LPCs and FSCs were positive $2 million and $6 million for the three and nine months ended September 30, 2014, respectively, and are reported through our consolidated statements of income in mortgage banking activities, net.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

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Note 10. Derivative Financial Instruments (continued)

Derivatives Designated as Cash Flow Hedges

To manage the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated certain interest rate swaps as cash flow hedges with an aggregate notional balance of $140 million.

For the three months ended September 30, 2014 and 2013, designated cash flow hedges decreased in value by $3 million and increased in value by $4 million, respectively, which was recorded in accumulated other comprehensive income, a component of equity. For the nine months ended September 30, 2014 and 2013, these cash flow hedges decreased in value by $17 million and increased in value by $25 million, respectively. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was $33 million and $16 million at September 30, 2014 and December 31, 2013, respectively. For both of the three months ended September 30, 2014 and 2013, we reclassified less than $100 thousand of unrealized losses on derivatives to interest expense. For the nine months ended September 30, 2014 and 2013, we reclassified $131 thousand and $219 thousand, respectively, of unrealized losses on derivatives to interest expense. Accumulated other comprehensive loss of less than $1 million will be amortized into interest expense, a component of our consolidated income statements, over the remaining life of the hedge liabilities.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and nine months ended September 30, 2014 and 2013.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2014**	**2013**	**2014**	**2013**
Net interest expense on cash flow interest rate agreements	$ (1,487)	$ (1,474)	$ (4,465)	$ (4,406)
Realized income (expense) due to ineffective portion of hedges	-	-	-	-
Realized net losses reclassified from other comprehensive income	(32)	(62)	(131)	(219)

Total Interest Expense	$	(1,519)	$	(1,536)	$	(4,596)	$	(4,625)

Derivative Counterparty Credit Risk

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. Each of our derivative counterparties that is not a clearinghouse must maintain compliance with International Swaps and Derivatives Association (ISDA) agreements or other similar agreements (or receive a waiver of non-compliance after a specific assessment) in order to conduct derivative transactions with us. Additionally, we review non-clearinghouse derivative counterparty credit standings, and in the case of a deterioration of creditworthiness, appropriate remedial action is taken. To further mitigate counterparty risk, we exit derivatives contracts with counterparties that (i) do not maintain compliance with (or obtain a waiver from) the terms of their ISDA or other agreements with us; or (ii) do not meet internally established guidelines regarding creditworthiness. Our ISDA and similar agreements currently require full bilateral collateralization of unrealized loss exposures with our derivative counterparties. Through a margin posting process, our positions are revalued with counterparties each business day and cash margin is generally transferred to either us or our derivative counterparties as collateral based upon the directional changes in fair value of the positions. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. With respect to certain of our derivatives, clearing and settlement is through one or more clearinghouses, which may be substituted as a counterparty. Clearing and settlement of derivative transactions through a clearinghouse is also intended to reduce specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 10. Derivative Financial Instruments (continued)

At September 30, 2014, we were in compliance with ISDA and similar agreements governing our open derivative positions. We assessed the risk associated with these counterparties as remote and did not record a specific valuation adjustment.

Note 11. Other Assets and Liabilities

Other assets at September 30, 2014 and December 31, 2013, are summarized in the following table.

Other Assets

(In Thousands)	September 30, 2014	December 31, 2013
Margin receivable	$ 56,217	$ 31,149
Investment receivable	24,814	8,923
Restricted investments	11,319	-
Other pledged collateral	5,000	5,000
FHLBC stock	4,846	-
REO	3,349	3,661
Prepaid expenses	2,350	1,850
Fixed assets and leasehold improvements	2,273	1,232
Other	2,600	1,825
Total Other Assets	$ 112,768	$ 53,640

Margin receivable resulted from margin calls from our swap, master repurchase agreements, and warehouse facilities counterparties that required us to post collateral. Investment receivable represents amounts due to us related to a commercial loan included in our Commercial Securitization that repaid prior to September 30, 2014, but for which we received the cash proceeds subsequent to quarter-end.

During the three months ended September 30, 2014, we transferred $11 million of U.S. Treasury securities to a custodial account related to a risk sharing arrangement we entered into during the same period.

The carrying value of REO at September 30, 2014, was $3 million, which includes the net effect of $5 million related to transfers into REO during the first nine months of 2014, offset by $5 million of REO liquidations. At September 30, 2014 and December 31, 2013, there were 16 and 20 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Sequoia Entities.

Our fixed assets included in the table above have a basis of $4 million and accumulated depreciation of $2 million.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 11. Other Assets and Liabilities (continued)

Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities at September 30, 2014 and December 31, 2013 are summarized in the following table.

(In Thousands)	September 30, 2014		December 31, 2013	
Accrued compensation	$	12,562	$	22,160
Legal reserve		10,400		12,000
MSR holdbacks payable		4,049		-
Residential repurchase reserve		3,771		1,771
Income tax payable		3,560		1,337
Derivative margin payable		2,873		4,700
Accrued operating expenses		2,170		4,291
Other		8,854		2,445
Total Other Liabilities	$	48,239	$	48,704

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

Note 12. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At September 30, 2014, we had outstanding agreements with 17 counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 *Management s Discussion and Analysis of Financial Condition and Results of Operations* of this Quarterly Report on Form 10-Q.

The table below summarizes the facilities that are available to us and the balances of short-term debt at September 30, 2014 and December 31, 2013 by the type of collateral securing the debt.

		September 30, 2014		
(Dollars in Thousands)	**Number of Facilities**	**Outstanding**	**Limit**	**Maturity**
Collateral Type				
Residential loans	5	$ 1,188,179	$ 1,550,000	12/2014-8/2015
Commercial loans	2	52,895	340,000	4/2015-9/2015
Real estate securities	10	646,614	-	10/2014-12/2014
Total	17	$ 1,887,688		

		December 31, 2013		
(Dollars in Thousands)	**Number of Facilities**	**Outstanding**	**Limit**	**Maturity**
Collateral Type				
Residential loans	5	$ 184,789	$ 1,400,000	1/2014 - 12/2014
Commercial loans	1	-	100,000	4/2014
Real estate securities	7	677,974	-	1/2014 - 2/2014
Total	13	$ 862,763		

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 12. Short-Term Debt (continued)

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At September 30, 2014, all of these borrowings were under uncommitted facilities except for $100 million that is committed under one commercial facility and were due within 364 days (or less) of the borrowing date. During the quarter, we transferred one commercial loan repurchase facility from long-term to short-term debt, due to its expiration falling within one year as of September 30, 2014.

The fair value of residential loans, commercial loans, and real estate securities pledged as collateral was $1.32 billion, $85 million, and $812 million, respectively, at September 30, 2014. For the three and nine months ended September 30, 2014, the average balance of short-term debt was $1.87 billion and $1.40 billion, respectively. At September 30, 2014 and December 31, 2013, accrued interest payable on short-term debt was $1.61 million and less than $1 million, respectively.

We also maintain a $10 million committed line of credit with one financial institution, which is secured by our pledge of certain mortgage-backed securities we own. At both September 30, 2014 and December 31, 2013, we had no outstanding borrowings on this facility.

Characteristics of Short-Term Debt

The table below summarizes short-term debt by weighted average interest rates and by collateral type at September 30, 2014 and December 31, 2013.

	September 30, 2014			December 31, 2013		
(Dollars in Thousands)	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
Collateral Type						
Residential loan collateral	$ 1,188,179	1.71%	216	$ 184,789	1.71%	228
Commercial loan collateral	52,895	5.15%	359	-	-	-
Real estate securities collateral	646,614	1.37%	23	677,974	1.34%	15
Total Short-Term Debt	$ 1,887,688	1.69%	154	$ 862,763	1.42%	61

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of short-term debt at September 30, 2014 and December 31, 2013.

(In Thousands)	**September 30, 2014**		**December 31, 2013**	
Within 30 days	$	548,890	$	659,262
31 to 90 days		213,330		54,434
Over 90 days		1,125,468		149,067
Total Short-Term Debt	$	1,887,688	$	862,763

Note 13. Asset-Backed Securities Issued

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 13. Asset-Backed Securities Issued (continued)

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

The carrying values of ABS issued by consolidated securitization entities we sponsored at September 30, 2014 and December 31, 2013, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

	September 30, 2014			
(Dollars in Thousands)	**Sequoia**	**Residential Resecuritization**	**Commercial Securitization**	**Total**
Certificates with principal balance	$ 1,495,988	$ 56,508	$ 114,943	$ 1,667,439
Interest-only certificates	2,318	-	-	2,318
Unamortized discount	(13,555)	-	-	(13,555)
Total ABS Issued	$ 1,484,751	$ 56,508	$ 114,943	$ 1,656,202
Range of weighted average interest rates, by series	0.08% to 4.26%	2.16%	5.62%	
Stated maturities	2014 - 2047	2046	2018	
Number of series	24	1	1	

	December 31, 2013			
(Dollars in Thousands)	**Sequoia**	**Residential Resecuritization**	**Commercial Securitization**	**Total**
Certificates with principal balance	$ 1,708,324	$ 94,934	$ 153,693	$ 1,956,951
Interest-only certificates	3,400	-	-	3,400

Unamortized discount	(17,389)	-	-	(17,389)
Total ABS Issued	$ 1,694,335	$ 94,934	$ 153,693	$ 1,942,962
Range of weighted average interest rates, by series	0.24% to 4.23%	2.21%	5.62%	
Stated maturities	2014 - 2047	2046	2018	
Number of series	24	1	1	

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its contractual maturity. At September 30, 2014, $1.64 billion of ABS issued ($1.65 billion principal balance) had contractual maturities beyond five years and $18 million of ABS issued ($18 million principal balance) had contractual maturities of less than one year. Amortization of Sequoia, Commercial Securitization, and Residential Resecuritization deferred ABS issuance costs was $2 million and $3 million for the nine months ended September 30, 2014 and 2013, respectively. The following table summarizes the accrued interest payable on ABS issued at September 30, 2014 and December 31, 2013. Interest due on consolidated ABS issued is payable monthly.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 13. Asset-Backed Securities Issued (continued)

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	September 30, 2014	December 31, 2013
Sequoia	$ 1,034	$ 1,218
Residential Resecuritization	7	11
Commercial Securitization	539	720
Total Accrued Interest Payable on ABS Issued	$ 1,580	$ 1,949

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at September 30, 2014 and December 31, 2013.

Collateral for Asset-Backed Securities Issued

	September 30, 2014			
(In Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Residential loans	$ 1,546,507	$ -	$ -	$ 1,546,507
Commercial loans	-	-	204,741	204,741
Real estate securities	-	233,311	-	233,311
Restricted cash	147	-	138	285
Accrued interest receivable	1,882	506	1,527	3,915
Other assets	3,349	-	21,699	25,048
Total Collateral for ABS Issued	$ 1,551,885	$ 233,817	$ 228,105	$ 2,013,807

	December 31, 2013			
(In Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total

Residential loans	$ 1,762,167	$ -	$ -	$ 1,762,167
Commercial loans	-	-	257,741	257,741
Real estate securities	-	263,204	-	263,204
Restricted cash	152	-	137	289
Accrued interest receivable	2,714	627	1,975	5,316
REO	3,661	-	-	3,661
Total Collateral for ABS Issued	$ 1,768,694	$ 263,831	$ 259,853	$ 2,292,378

Note 14. Long-Term Debt

FHLBC Borrowings

In July 2014, we entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. Under this agreement, we may incur borrowings, also referred to as advances, from time to time from the FHLBC secured by eligible collateral, including, but not limited to residential mortgage loans and residential mortgage-backed securities. As of September 30, 2014, $204 million of advances were outstanding under this agreement with a weighted average interest rate of 0.2524% and a weighted average maturity of 8.9 years. Advances under this agreement are charged interest based on a specified margin over the FHLBC s 13-week discount note rate, which resets every 13 weeks. These advances were secured by residential mortgage loans with a fair value of $238 million as of September 30, 2014. This agreement also requires us to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of our advances. As of September 30, 2014, we held $5 million of FHLBC stock that is included in other assets in our consolidated balance sheets.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 14. Long-Term Debt (continued)

Commercial Long-Term Debt

Commercial long-term debt reported in periods prior to the third quarter of 2014 includes borrowings under a master repurchase agreement that, as of the date reported, expired in more than one year with a financial institution counterparty. Beginning in the third quarter of 2014, amounts previously classified as commercial long-term debt were reclassified to short-term debt due to the associated agreement expiring in less than one year as of September 30, 2014.

Commercial Secured Borrowing

At September 30, 2014, we had commercial secured borrowings of $66 million resulting from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. We bifurcated certain of our senior commercial mortgage loans into a senior portion that was sold to a third party and a junior portion that we retained as an investment. Although GAAP requires us to record a secured borrowing liability when we receive cash from selling the senior portion of the loan, the liability has no economic substance to us in that it does not require periodic interest payments and has no maturity. For each commercial secured borrowing, at such time that the associated senior portion of the loan is repaid or we sell our retained junior portion, the secured borrowing liability and associated senior portion of the loan would be derecognized from our balance sheet.

Convertible Notes

In March 2013, we issued $287.5 million principal amount of 4.625% convertible senior notes due 2018. These convertible notes require semi-annual interest distributions at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. Including amortization of deferred securities issuance costs, the interest expense yield on our convertible notes was 5.49% and 5.44% for the three and nine months ended September 30, 2014, respectively. At September 30, 2014, the accrued interest payable balance on this debt was $6 million.

At September 30, 2014, our convertible senior notes were convertible at the option of the holder at a conversion rate of 41.1320 common shares per $1,000 principal amount of convertible senior notes (equivalent to a conversion price of $24.31 per common share). Upon conversion of these convertible senior notes by a holder, the holder will receive shares of our common stock.

Trust Preferred Securities and Subordinated Notes

At September 30, 2014, we had trust preferred securities and subordinated notes outstanding of $100 million and $40 million, respectively. The interest expense yield on both our trust preferred securities and subordinated notes was 2.58% and 2.65% for the nine months ended September 30, 2014 and 2013, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on both our trust preferred securities and subordinated notes was 6.88% and 6.90% for the nine months ended September 30, 2014 and 2013, respectively.

At both September 30, 2014 and December 31, 2013, the accrued interest payable balance on our trust preferred securities and subordinated notes was less than $1 million. Under the terms of this long-term debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this long-term debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is *pari passu* or subordinate to this long-term debt.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2014

(Unaudited)

Note 15. Commitments and Contingencies

Lease Commitments

At September 30, 2014, we were obligated under eight non-cancelable operating leases with expiration dates through 2021 for $14 million. Operating lease expense was $2 million and $1 million for the nine months ended September 30, 2014 and 2013, respectively.

The following table presents our future lease commitments at September 30, 2014.

Future Lease Commitments by Year

(In Thousands)		**September 30, 2014**
2014 (3 months)	$	751
2015		3,061
2016		2,832
2017		2,879
2018		1,827
2019 and thereafter		2,683
Total	$	14,033

Loss Contingencies Residential Repurchase Reserve

We maintain a repurchase reserve for potential obligations arising from representation and warranty violations related to the residential loans we have sold to securitization trusts or third parties and for conforming residential loans associated with MSRs that we have purchased from third parties. We do not originate residential loans and we believe the initial risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans. However, in some cases, for example, where loans were acquired from companies that have since become insolvent, repurchase claims may result in our being liable for a repurchase obligation.

At September 30, 2014 and December 31, 2013, our repurchase reserve associated with our residential loans and MSRs was $4 million and $1.8 million, respectively. This liability is recorded in accrued expenses and other liabilities in our consolidated balance sheets and the provision for repurchase expense is included in mortgage banking activities, net and MSR income, net in our consolidated statements of income.

Loss Contingencies Litigation

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the Seattle Certificate) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the 2005-4 RMBS) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys fees and costs. The Seattle Certificate was issued with an original principal amount of approximately $133 million, and, as of September 30, 2014, the FHLB-Seattle has received approximately $115.4 million of principal and $11.1 million of interest payments in respect of the Seattle Certificate. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle s claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2014

(Unaudited)

Note 15. Commitments and Contingencies (continued)

On or about July 15, 2010, The Charles Schwab Corporation (Schwab) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the Schwab Defendants) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the Schwab Certificate) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. Schwab alleges a claim for negligent misrepresentation under California state law and seeks unspecified damages and attorneys fees and costs. The Schwab Certificate was issued with an original principal amount of approximately $14.8 million, and, as of September 30, 2014, Schwab has received approximately $12.8 million of principal and $1.3 million of interest payments in respect of the Schwab Certificate. SRF has denied Schwab s allegations. This case is in discovery, and no trial date has been set. We intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named as defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

In October 2010, a complaint was filed in Illinois state court against SRF and more than 45 other named defendants alleging that the defendants made false or misleading statements in offering materials for various RMBS sold or issued by the defendants or entities controlled by them. The plaintiff subsequently amended the complaint to name Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc., as defendants. With respect to Redwood Trust, Inc., RWT Holdings, Inc., and SRF (the Redwood Defendants), the plaintiff alleged that there were false or misleading statements in the offering materials for two mortgage pass-through certificates issued in the Sequoia Mortgage Trust 2006-1 securitization transaction. In October 2014, the plaintiff and the Redwood Defendants agreed to settle the complaint on mutually satisfactory terms. The terms of the agreed-upon settlement remain confidential.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At September 30, 2014, the aggregate amount of loss contingency reserves established in respect of the three above-referenced litigation matters was $10.4 million. Included within this aggregate reserve is the amount the Redwood Defendants agreed to pay pursuant to the confidential settlement reached in October 2014, which amount was paid subsequent to September 30, 2014. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 15. Commitments and Contingencies (continued)

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

Note 16. Equity

The following table provides a summary of changes to accumulated other comprehensive income by component for the three and nine months ended September 30, 2014 and 2013.

Changes in Accumulated Other Comprehensive Income by Component

	Three Months Ended September 30, 2014		Three Months Ended September 30, 2013	
(In Thousands)	**Net unrealized gains on available-for-sale securities**	**Net unrealized losses on interest rate agreements accounted for as cash flow hedges**	**Net unrealized gains on available-for-sale securities**	**Net unrealized losses on interest rate agreements accounted for as cash flow hedges**
Balance at beginning of period	$ 197,542	$ (29,985)	$ 145,349	$ (27,066)

Other comprehensive income (loss) before reclassifications	1,849	(3,258)	(633)	4,018
Amounts reclassified from other accumulated comprehensive income	(6,409)	32	(6,962)	62
Net current-period other comprehensive (loss) income	(4,560)	(3,226)	(7,595)	4,080
Balance at End of Period	$ 192,982	$ (33,211)	$ 137,754	$ (22,986)

	Nine Months Ended September 30, 2014		**Nine Months Ended September 30, 2013**	
(In Thousands)	**Net unrealized gains on available-for-sale securities**	**Net unrealized losses on interest rate agreements accounted for as cash flow hedges**	**Net unrealized gains on available-for-sale securities**	**Net unrealized losses on interest rate agreements accounted for as cash flow hedges**
Balance at beginning of period	$ 164,654	$ (15,888)	$ 186,580	$ (48,248)
Other comprehensive income (loss) before reclassifications	35,078	(17,454)	(29,615)	25,043
Amounts reclassified from other accumulated comprehensive income	(6,750)	131	(19,211)	219
Net current-period other comprehensive (loss) income	28,328	(17,323)	(48,826)	25,262
Balance at End of Period	$ 192,982	$ (33,211)	$ 137,754	$ (22,986)

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(Unaudited)

Note 16. Equity (continued)

The following table provides a summary of reclassifications out of accumulated other comprehensive income for three and nine months ended September 30, 2014 and 2013.

Reclassifications Out of Accumulated Other Comprehensive Income

		Amount reclassified from accumulated other comprehensive income Three Months Ended September 30,			
(In Thousands)	**Affected Line Item in the Income Statement**		**2014**		**2013**
Net realized gains (losses) on AFS securities					
Other than temporary impairment	Other market valuations, net	$	188	$	-
Gain on sale of AFS securities	Realized gains, net		(6,597)		(6,962)
		$	(6,409)	$	(6,962)
Net realized gains on interest rate agreements designated as cash flow hedges					
Amortization of deferred loss	Interest expense	$	32	$	62
		$	32	$	62

		Amount reclassified from accumulated other comprehensive income Nine Months Ended September 30,			
(In Thousands)	**Affected Line Item in the Income Statement**		**2014**		**2013**
Net realized gains (losses) on AFS securities					
Other than temporary impairment	Other market valuations, net	$	565	$	(124)
Gain on sale of AFS securities	Realized gains, net		(7,315)		(19,087)

		$	(6,750)	$	(19,211)
Net realized gains on interest rate agreements designated as cash flow hedges					
Amortization of deferred loss	Interest expense	$	131	$	219
		$	131	$	219

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Note 16. Equity (continued)

Earnings Per Common Share

The following table provides the basic and diluted earnings per common share computations for the three and nine months ended September 30, 2014 and 2013.

Basic and Diluted Earnings Per Common Share

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands, Except Share Data)	**2014**	**2013**	**2014**	**2013**
Basic Earnings Per Common Share:				
Net income attributable to Redwood	$ 45,097	$ 21,929	$ 73,447	$ 148,112
Less: Dividends and undistributed earnings allocated to participating securities	(1,054)	(565)	(1,819)	(4,209)
Net income allocated to common shareholders	$ 44,043	$ 21,364	$ 71,628	$ 143,903
Basic weighted average common shares outstanding	83,017,534	82,201,473	82,722,079	81,888,231
Basic Earnings Per Common Share	$ 0.53	$ 0.26	$ 0.87	$ 1.76
Diluted Earnings Per Common Share:				
Net income attributable to Redwood	$ 45,097	$ 21,929	$ 73,447	$ 148,112
Less: Dividends and undistributed earnings allocated to participating securities	(756)	(565)	(1,784)	(3,030)
Add back: Interest expense on convertible notes	3,855	-	-	8,790
Net income allocated to common shareholders	$ 48,196	$ 21,364	$ 71,663	$ 153,872
Weighted average common shares outstanding	83,017,534	82,201,473	82,722,079	81,888,231
Net effect of dilutive equity awards	2,113,248	2,220,566	2,309,051	2,292,451

Net effect of assumed convertible notes conversion to common shares	11,825,450	-	-	9,053,183
Diluted weighted average common shares outstanding	96,956,232	84,422,039	85,031,130	93,233,865
Diluted Earnings Per Common Share	$ 0.50	$ 0.25	$ 0.84	$ 1.65

For the three and nine months ended September 30, 2014, there were 2,113,248 and 2,309,051 of dilutive equity awards, respectively, determined under the two-class method. For the three and nine months ended September 30, 2013, there were 2,220,566 and 2,292,451 of dilutive equity awards, respectively, 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. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances. For the three and nine months ended September 30, 2014, common shares related to the assumed conversion of the convertible notes, totaling 11,825,450 and zero, respectively, were included in the calculation of diluted earnings per share. For the three and nine months ended September 30, 2013, common shares related to the assumed conversion of the convertible notes, totaling zero and 9,053,183, respectively, were included in the calculation of the diluted earnings per share.

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Note 16. Equity (continued)

For the nine months ended September 30, 2014, as well as for the three months ended September 30, 2013, 11,825,450 common shares related to the assumed conversion of the convertible notes were antidilutive and were excluded in the calculation of diluted earnings per share. For the three months ended September 30, 2014 and 2013, the number of outstanding equity awards that were antidilutive totaled 57,514 and 190,627, respectively. For the nine months ended September 30, 2014 and 2013, the number of outstanding equity awards that were antidilutive totaled 66,129 and 244,174 respectively, under the two-class method. There were no other participating securities during these periods.

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 nine months ended September 30, 2014, there were no shares acquired under the plan. At September 30, 2014, there remained 4,005,985 shares available for repurchase under this plan.

Note 17. Equity Compensation Plans

At September 30, 2014 and December 31, 2013, 2,603,630 and 1,683,956 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled $14 million at September 30, 2014, as shown in the following table.

	Nine Months Ended September 30, 2014					
(In Thousands)	**Stock Options**	**Restricted Stock**	**Deferred Stock Units**	**Performance Stock Units**	**Employee Stock Purchase Plan**	**Total**
Unrecognized compensation cost at beginning of period	$ -	$ 1,869	$ 13,044	$ 5,817	$ -	$ 20,730
Equity grants	-	94	1,187	-	215	1,496
Equity grant forfeitures	-	(213)	(150)	-	-	(363)
Equity compensation expense	-	(509)	(4,549)	(2,196)	(161)	(7,415)

Unrecognized Compensation Cost at End of Period	$ -	$ 1,241	$ 9,532	$ 3,621	$ 54	$ 14,448

At September 30, 2014, the weighted average amortization period remaining for all of our equity awards was less than two years.

Stock Options

At September 30, 2014 and December 31, 2013, there were 57,514 and 79,535 fully vested stock options outstanding, respectively. There was no aggregate intrinsic value for the options outstanding and exercisable at September 30, 2014. For both the nine months ended September 30, 2014 and 2013, there were no stock options exercised. For the nine months ended September 30, 2014, 22,021 stock options expired.

Restricted Stock

At September 30, 2014 and December 31, 2013, there were 110,948 and 166,941 shares, respectively, of restricted stock awards outstanding. Restrictions on these shares lapse through 2018. During the nine months ended September 30, 2014, there were 2,574 restricted stock awards granted, 42,725 restricted stock awards that vested and were distributed, and 15,842 restricted stock awards forfeited.

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Note 17. Equity Compensation Plans (continued)

Deferred Stock Units (DSUs)

At September 30, 2014 and December 31, 2013, there were 1,961,038 and 2,266,473 DSUs, respectively, outstanding of which 1,218,012 and 1,263,420, respectively, had vested. There were 142,983 DSUs granted and 7,870 DSUs forfeited related to employee departures during the nine months ended September 30, 2014. During the nine months ended September 30, 2014, there were 440,548 of DSU distributions and cash distributions of less than $1 million to participants in the EDCP. Unvested DSUs at September 30, 2014 vest through 2018.

Performance Stock Units (PSUs)

At both September 30, 2014 and December 31, 2013, the target number of PSUs that were unvested was 779,871. PSUs do not vest until the third anniversary of their grant date, with the level of vesting at that time contingent on total stockholder return (defined as the change in our common stock price plus dividends paid on our common stock relative to the per share price of our common stock on the date of the PSU grant) over the three-year vesting period (Three-Year TSR). The number of underlying shares of our common stock that will vest during 2014 and in future years will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the target number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period. During the nine months ended September 30, 2014, 351,640 shares of common stock underlying vested PSUs were distributed.

Employee Stock Purchase Plan

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. At September 30, 2014 and December 31, 2013, 266,463 and 243,020 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

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Note 18. Mortgage Banking Activities

The following table presents the components of mortgage banking activities, net, recorded in our consolidated income statements for the three and nine months ended September 30, 2014 and 2013.

Components of Mortgage Banking Activities, Net

(In Thousands)	Three Months Ended September 30, 2014	2013	Nine Months Ended September 30, 2014	2013
Residential mortgage banking activities:				
Changes in fair value of:				
Residential loans, at fair value	$ 13,446	$ (10,804)	$ 34,554	$ (17,339)
Sequoia IO securities	(1,332)	(1,866)	(14,419)	36,399
Risk management derivatives (1)	(4,297)	75	(16,433)	48,583
Loan purchase and forward sale commitments	2,487	-	6,077	-
Other (2)	1,082	359	1,871	1,635
Total residential mortgage banking activities:	11,386	(12,236)	11,650	69,278
Commercial mortgage banking activities:				
Changes in fair value of:				
Commercial loans, at fair value	4,305	3,171	13,644	2,826
Risk management derivatives (1)	1,892	367	(1,726)	2,426
Other (2)	289	-	382	1
Net gains on commercial loan originations and sales	-	-	-	11,031
Total commercial mortgage banking activities:	6,486	3,538	12,300	16,284
Mortgage Banking Activities, Net	$ 17,872	$ (8,698)	$ 23,950	$ 85,562

(1) Represents market valuation changes of derivatives that are used to manage risks associated with our accumulation of residential and commercial loans.
(2) Amounts in this line item include other fee income and the provision for repurchase expenses, presented net.

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Note 19. Operating Expenses

Components of our operating expenses for the three and nine months ended September 30, 2014 and 2013 are presented in the following table.

Operating Expenses

(In Thousands)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Fixed compensation expense	$ 7,445	$ 5,808	$ 21,109	$ 17,524
Variable compensation expense	2,418	5,621	8,170	14,418
Equity compensation expense	2,261	1,997	7,415	7,880
Severance expense	4	445	226	3,879
Total compensation expense	12,128	13,871	36,920	43,701
Systems and consulting	3,463	2,780	10,906	6,840
Accounting and legal	1,223	2,066	4,039	5,118
Office costs	1,282	829	3,437	2,444
Corporate costs	569	508	1,679	1,545
Other operating expenses	2,741	2,266	6,679	7,289
Total Operating Expenses	$ 21,406	$ 22,320	$ 63,660	$ 66,937

Note 20. Taxes

For the nine months ended September 30, 2014 and 2013, we recognized a provision for income taxes of $4 million and $9 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at September 30, 2014 and 2013.

Reconciliation of Statutory Tax Rate to Effective Tax Rate

	September 30, 2014	September 30, 2013
Federal statutory rate	34.0 %	34.0 %
State statutory rate, net of Federal tax effect	7.2 %	7.2 %

Differences in taxable (loss) income from GAAP income	(10.0)%	(2.1)%
Change in valuation allowance	(1.0)%	(18.5)%
Dividends paid deduction	(25.4)%	(14.8)%
Effective Tax Rate	4.8 %	5.8 %

We assessed our tax positions for all open tax years (Federal years 2011 to 2014, State years 2010 to 2014) and, at September 30, 2014 and December 31, 2013, concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

Note 21. Segment Information

Redwood operates in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. The accounting policies of the reportable segments are the same as those described in *Note 3* Summary of Significant Accounting Policies. For a full description of our segments, see *Note 1* Redwood Trust.

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Note 21. Segment Information (continued)

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

The following tables present financial information by segment for the three and nine months ended September 30, 2014 and 2013.

Business Segment Financial Information

	Three Months Ended September 30, 2014				
(In Thousands)	**Residential Mortgage Banking**	**Residential Investments**	**Commercial Mortgage Banking and Investments**	**Corporate/ Other**	**Total**
Interest income	$ 16,911	$ 27,600	$ 12,603	$ 6,237	$ 63,351
Interest expense	(4,192)	(3,142)	(4,526)	(11,490)	(23,350)
Net interest income (loss)	12,719	24,458	8,077	(5,253)	40,001
Reversal of provision (provision) for loan losses	-	-	888	708	1,596
Mortgage banking activities, net	11,386	-	6,486	-	17,872
MSR income (loss), net	-	5,821	-	-	5,821
Other market valuation adjustments, net	43	(3,371)	-	(378)	(3,706)
Realized gains, net	-	7,836	-	696	8,532
Operating expenses	(9,982)	(802)	(2,279)	(8,343)	(21,406)
Other income	-	-	-	1,600	1,600
(Provision for) benefit from income taxes	(3,352)	150	(1,764)	(247)	(5,213)
Segment Contribution	$ 10,814	$ 34,092	$ 11,408	$ (11,217)	

Net Income					$ 45,097
Non-cash amortization income (expense)	(43)	10,890	(191)	(2,049)	8,607

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Note 21. Segment Information (continued)

	Three Months Ended September 30, 2013				
(In Thousands)	Residential Mortgage Banking	Residential Investments	Commercial Mortgage Banking and Investments	Corporate/ Other	Total