

REDWOOD TRUST INC  
Form 10-Q  
August 04, 2010

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

**FORM 10-Q**

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

**For the Quarterly Period Ended: June 30, 2010**

**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  
(State or Other Jurisdiction of  
Incorporation or Organization)

68-0329422  
(I.R.S. Employer  
Identification No.)

One Belvedere Place, Suite 300  
Mill Valley, California  
(Address of Principal Executive Offices)

94941  
(Zip Code)

**(415) 389-7373**

(Registrant's Telephone Number, Including Area Code)

**Not Applicable**

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

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

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

77,979,850 shares outstanding as of August 3, 2010

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

| (In Thousands, Except Share Data)<br>(Unaudited)   | June 30,<br>2010 | December 31,<br>2009 |
|--|------------------|----------------------|
| <b>ASSETS</b>  |                  |                      |
| Real estate loans  | \$3,810,155      | \$3,739,254          |
| Real estate securities, at fair value:   |                  |                      |
| Trading securities   | 275,994          | 277,274              |
| Available-for-sale securities  | 740,963          | 810,471              |
| Total real estate securities   | 1,016,957        | 1,087,745            |
| Other investments  | 3,654            | 20,371               |
| Cash and cash equivalents  | 288,376          | 242,818              |
| Total earning assets   | 5,119,142        | 5,090,188            |
| Restricted cash  | 26,814           | 94,306               |
| Accrued interest receivable  | 14,085           | 18,193               |
| Derivative assets  | 4,735            | 12,372               |
| Deferred tax asset   | 2,452            | 4,810                |
| Deferred asset-backed securities issuance costs  | 7,045            | 6,639                |
| Other assets   | 45,312           | 26,142               |
| Total Assets <sup>(1)</sup>  | \$5,219,585      | \$5,252,650          |
| <b>LIABILITIES AND EQUITY</b>  |                  |                      |
| Liabilities  |                  |                      |
| Short-term debt  | \$               | \$                   |
| Accrued interest payable   | 6,315            | 5,968                |
| Derivative liabilities   | 106,355          | 83,800               |
| Accrued expenses and other liabilities   | 10,184           | 71,828               |
| Dividends payable  | 19,477           | 19,434               |
| Asset-backed securities issued Sequoia   | 3,681,622        | 3,644,933            |
| Asset-backed securities issued Acacia  | 253,104          | 297,596              |
| Long-term debt   | 140,000          | 140,000              |
| Total liabilities <sup>(2)</sup>   | 4,217,057        | 4,263,559            |
| Equity   |                  |                      |
| Common stock, par value \$0.01 per share, 100,000,000 shares authorized;<br>77,908,439 and 77,737,130 issued and outstanding | 779              | 777                  |
| Additional paid-in capital   | 1,684,304        | 1,674,367            |
| Accumulated other comprehensive income   | 38,199           | 64,860               |
| Cumulative earnings  | 440,332          | 364,888              |

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|  |             |             |
|--|-------------|-------------|
| Cumulative distributions to stockholders | (1,173,079) | (1,133,171) |
| Total stockholders' equity               | 990,535     | 971,721     |
| Noncontrolling interest                  | 11,993      | 17,370      |
| Total equity                             | 1,002,528   | 989,091     |
| Total Liabilities and Equity             | \$5,219,585 | \$5,252,650 |

Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be (1) used to settle obligations of these VIEs. At June 30, 2010, these assets totaled \$4,139,970, net of noncontrolling interest.

(2) Our consolidated balance sheets include liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At June 30, 2010, these liabilities totaled \$4,023,219.

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

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TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME (LOSS)**

| (In Thousands, Except Share Data)<br>(Unaudited)                            | Three Months Ended June 30, |            | Six Months Ended June 30, |              |
|---|-----------------------------|------------|---------------------------|--------------|
|   | 2010                        | 2009       | 2010                      | 2009         |
| Interest Income   |                             |            |                           |              |
| Real estate loans   | \$ 16,015                   | \$ 30,614  | \$ 30,808                 | \$ 64,583    |
| Real estate securities  | 40,458                      | 43,475     | 84,357                    | 90,737       |
| Other investments   | 4                           | 55         | 13                        | 131          |
| Cash and cash equivalents   | 93                          | 117        | 110                       | 247          |
| Total interest income   | 56,570                      | 74,261     | 115,288                   | 155,698      |
| Interest Expense  |                             |            |                           |              |
| Short-term debt   | (36 )                       |            | (36 )                     |              |
| Asset-backed securities issued  | (18,988 )                   | (37,499 )  | (36,054 )                 | (83,332 )    |
| Long-term debt  | (2,140 )                    | (1,502 )   | (3,256 )                  | (3,310 )     |
| Total interest expense  | (21,164 )                   | (39,001 )  | (39,346 )                 | (86,642 )    |
| Net Interest Income   | 35,406                      | 35,260     | 75,942                    | 69,056       |
| Provision for loan losses   | (4,321 )                    | (14,545 )  | (13,797 )                 | (30,577 )    |
| Market valuation adjustments on trading instruments                         | (2,909 )                    | 4,102      | (12,200 )                 | (10,107 )    |
| Other-than-temporary impairments <sup>(1)</sup>                             | (4,216 )                    | (33,237 )  | (6,162 )                  | (62,272 )    |
| Market valuation adjustments, net   | (7,125 )                    | (29,135 )  | (18,362 )                 | (72,379 )    |
| Net Interest Income (Loss) After Provision and Market Valuation Adjustments | 23,960                      | (8,420 )   | 43,783                    | (33,900 )    |
| Operating expenses  | (11,227 )                   | (10,769 )  | (28,533 )                 | (21,308 )    |
| Realized gains, net   | 16,080                      | 25,525     | 60,417                    | 25,988       |
| Net income (loss) before provision for income taxes                         | 28,813                      | 6,336      | 75,667                    | (29,220 )    |
| (Provision for) benefit from income taxes                                   | (26 )                       | 514        | (52 )                     | 409          |
| Net income (loss)   | 28,787                      | 6,850      | 75,615                    | (28,811 )    |
| Less: Net income (loss) attributable to noncontrolling interest             | 186                         | 127        | 171                       | (589 )       |
| Net Income (Loss) Attributable to Redwood Trust, Inc.                       | \$ 28,601                   | \$ 6,723   | \$ 75,444                 | \$ (28,222 ) |
| Basic earnings (loss) per common share:                                     | \$ 0.36                     | \$ 0.10    | \$ 0.94                   | \$ (0.48 )   |
| Diluted earnings (loss) per common share:                                   | \$ 0.35                     | \$ 0.10    | \$ 0.94                   | \$ (0.48 )   |
| Regular dividends declared per common share                                 | \$ 0.25                     | \$ 0.25    | \$ 0.50                   | \$ 0.50      |
| Special dividends declared per common share                                 |                             |            |                           |              |
| Total dividends declared per common share                                   | \$ 0.25                     | \$ 0.25    | \$ 0.50                   | \$ 0.50      |
| Basic weighted average shares outstanding                                   | 77,800,642                  | 65,697,887 | 77,739,279                | 59,137,864   |
| Diluted weighted average shares outstanding                                 | 78,852,259                  | 66,362,723 | 78,661,642                | 59,137,864   |

(1)

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For the three months ended June 30, 2010, other-than-temporary impairments were \$7,086, of which \$2,870 were recognized in Accumulated Other Comprehensive Income (Loss). For the six months ended June 30, 2010, other-than-temporary impairments were \$10,701, of which \$4,539 were recognized in Accumulated Other Comprehensive Income (Loss).

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



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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF EQUITY AND  
COMPREHENSIVE INCOME (LOSS)**

**For the Six Months Ended June 30, 2010**

**For the Six Months Ended June 30, 2009**

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

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

| (In Thousands, Except Share Data)<br>(Unaudited)   | Six Months Ended June<br>30, |             |
|--|------------------------------|-------------|
|  | 2010                         | 2009        |
| <b>Cash Flows From Operating Activities:</b>   |                              |             |
| Net income (loss) attributable to Redwood Trust, Inc.  | \$75,444                     | \$(28,222 ) |
| Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities: |                              |             |
| Amortization of premiums, discounts, and debt issuance costs, net                                  | (16,409 )                    | 3,493       |
| Depreciation and amortization of non-financial assets  | 439                          | 539         |
| Provision for loan losses  | 13,797                       | 30,577      |
| Non-cash equity award compensation   | 8,208                        | 4,156       |
| Market valuation adjustments, net  | 18,362                       | 72,379      |
| Realized gains, net  | (60,417 )                    | (25,988 )   |
| Net change in:   |                              |             |
| Accrued interest receivable  | 3,732                        | 9,738       |
| Deferred tax asset   | 2,358                        | 1,325       |
| Other assets   | (13,079 )                    | 30,193      |
| Accrued interest payable   | 5,602                        | (11,549 )   |
| Accrued expenses and other liabilities   | (61,644 )                    | 22,280      |
| Net cash (used in) provided by operating activities  | (23,607 )                    | 108,921     |
| <b>Cash Flows From Investing Activities:</b>   |                              |             |
| Purchases of real estate loans held-for-investment   | (238,076)                    |             |
| Principal payments on real estate loans held-for-investment  | 148,647                      | 199,516     |
| Purchases of real estate securities available-for-sale   | (186,057)                    | (438,669)   |
| Proceeds from sales of real estate securities available-for-sale                                   | 247,528                      | 57,898      |
| Principal payments on real estate securities available-for-sale                                    | 71,083                       | 52,372      |
| Purchases of real estate securities trading  | (17,137 )                    |             |
| Proceeds from sales of real estate securities trading  | 6,119                        |             |
| Principal payments on real estate securities trading   | 31,102                       | 50,942      |
| Principal payments on other investments  | 9,675                        | 14,279      |
| Net decrease (increase) in restricted cash   | 67,492                       | (12,616 )   |
| Net cash provided by (used in) investing activities  | 140,376                      | (76,278 )   |
| <b>Cash Flows From Financing Activities:</b>   |                              |             |
| Proceeds from issuance of asset-backed securities  | 211,178                      |             |
| Repurchase of asset-backed securities  | (8,639 )                     |             |
| Deferred asset-backed security issuance costs  | (1,667 )                     |             |
| Repayments on asset-backed securities  | (200,214)                    | (271,626)   |
| Net settlements of derivatives   | (26,268 )                    | (24,702 )   |
| Net proceeds from issuance of common stock   | 1,731                        | 520,546     |
| Dividends paid   | (39,865 )                    | (42,147 )   |

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|   |           |           |
|---|-----------|-----------|
| Change in noncontrolling interests                  | (7,467 )  | (4,119 )  |
| Net cash (used in) provided by financing activities | (71,211 ) | 177,952   |
| Net increase in cash and cash equivalents           | 45,558    | 210,595   |
| Cash and cash equivalents at beginning of period    | \$242,818 | \$126,480 |
| Cash and cash equivalents at end of period          | \$288,376 | \$337,075 |
| Supplemental Disclosures:                           |           |           |
| Cash paid for interest                              | \$32,646  | \$105,591 |
| Cash paid for taxes                                 | \$15      | \$70      |
| Dividends declared but not paid at end of period    | \$19,477  | \$19,376  |

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

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## REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2010 (Unaudited)

### Note 1. Redwood Trust

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

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

### Note 2. Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2010 and December 31, 2009, and for the three and six months ended June 30, 2010 and 2009. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States for interim financial information and with the Securities and Exchange Commission's (SEC) instructions to Form 10-Q and Article 10 of Regulation S-X. Results for the three and six months ended June 30, 2010, may not necessarily be indicative of the results for the year ending December 31, 2010. These unaudited interim consolidated financial statements should be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2009. All amounts presented herein, except per share data, are shown in thousands.

We recognize the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* as a replacement of FASB Statement No. 162 (FAS 168), which establishes the Accounting Standards Codification (ASC) as the single source of authoritative GAAP in the United States.

### Organization

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

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

We do not service any assets, including assets owned by the Fund, Sequoia, or Acacia.

## **Principles of Consolidation**

We apply ASC 860 and ASC 810-10 to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. These standards became effective for our interests in all VIEs as of January 1, 2010, except for the Fund, as a result of the FASB's decision to delay the applicability of ASC 810-10 for private equity funds. Our determination of whether we must consolidate the Fund was made in accordance with FASB Interpretation No. 46 (revised), *Consolidation of Variable Interest Entities* (FIN 46(R)), at the time we acquired our interests in the Fund.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

**Note 2. Basis of Presentation (continued)**

We currently consolidate the assets, liabilities, and noncontrolling interests of the Fund, as well as the assets and liabilities of the Sequoia and the Acacia securitization entities where we maintain continuing involvement. For financial reporting purposes, the real estate securities owned at the Fund are shown on our consolidated balance sheets under real estate securities and the portion of the Fund owned by third parties is shown under noncontrolling interest. In our consolidated statements of income (loss), we record interest income on the securities owned at the Fund. Since the Fund is currently funded with equity, there is no associated interest expense. The underlying loans and securities owned at Sequoia and Acacia entities are shown on our consolidated balance sheets under real estate loans and real estate securities and the asset-back securities (ABS) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income (loss), we record interest income on the loans and securities owned by consolidated Sequoia and Acacia entities and interest expense on the ABS issued by these entities.

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

**Note 3. Summary of Significant Accounting Policies**

**Use of Estimates**

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

**Fair Value 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 the consolidated statements of income (loss).

Our decision to apply the fair value option for new financial instruments is generally based upon our funding strategy for the specific financial asset acquired. For example, securities that we anticipate funding with equity will generally

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

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

## **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;

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

Relevant reports issued by analysts and rating agencies;

The current level of interest rates and any directional movements in relevant indices, such as credit risk indices; Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;

Indicative prices or yields from broker/dealers; and,

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

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

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

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

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

**Real Estate Loans**

**Residential and Commercial Real Estate Loans    Fair Value**

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



(loss) in market valuation adjustments, net.

### **Residential and Commercial Real Estate Loans Held-for-Sale**

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

**Residential and Commercial Real Estate Loans Held-for-Investment**

Real estate loans held-for-investment include residential real estate loans owned and securitized at Sequoia entities and commercial real estate loans owned at Redwood. These loans are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Interest previously accrued for loans that have become greater than 90 days past due is reserved for in the allowance for loan losses. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due is used to reduce the outstanding loan principal balance.

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

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

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

**Real Estate Loans Allowance for Loan Losses**

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

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

Ongoing analyses of loans, including, but not limited to, the age of loans, underwriting standards, business climate, economic conditions, and other observable data;

Historical loss rates and past performance of similar loans;

Relevant environmental factors;  
Relevant market research and publicly available third-party reference loss rates;  
Trends in delinquencies and charge-offs;  
Effects and changes in credit concentrations;  
Information supporting a borrower's ability to meet obligations;  
Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and,  
Discounted cash flow analyses.

Once we determine the amount of defaults, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each individual loan or pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an appropriate loss confirmation period. This period is defined as the range of time between the occurrence of a credit loss (such as the initial

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 3. Summary of Significant Accounting Policies**  
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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 as of the reported date of the financial statements. We re-evaluate the adequacy of our allowance for loan losses at least quarterly.

As part of the loss mitigation efforts undertaken by servicers of residential loans owned by Sequoia securitization entities, a growing number of loan modifications have been completed to help make mortgage loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal amounts owed on a mortgage loan; and, (iv) extension of the contractual maturity of a mortgage loan. We evaluate all loan modifications performed by servicers to determine if they constitute troubled debt restructurings according to GAAP. If a loan is determined to be a troubled debt restructuring, 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 the consolidated statements of income (loss).

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

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

**Real Estate Securities, at Fair Value**

**Trading Securities**

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

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

### **Available-for-Sale Securities**

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

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

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

In the second quarter of 2009, as part of our adoption of new authoritative GAAP that we currently use to evaluate impairments on AFS securities, we evaluated \$450 million of previously recorded OTTI on securities still held at April 1, 2009. We determined that \$224 million of these OTTI related to securities where we either had the intent to sell or the OTTI did not include a non-credit component. The remaining \$226 million of these OTTI related to securities that included a \$165 million aggregate credit component and a \$61 million aggregate non-credit component (of which \$60 million related to Redwood's interest and \$1 million related to noncontrolling interest at the Fund). In accordance with the adoption guidance, we recorded a \$61 million one-time cumulative-effect adjustment, net of any related tax effects, to reclassify the non-credit component of these OTTI previously recorded through our consolidated statements of income (loss), as was prescribed under previous GAAP. This reclassification increased retained earnings and decreased other comprehensive income (OCI), resulting in zero net impact to reported stockholders' equity and

noncontrolling interest.

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

## **Other Investments**

Other investments include a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial statement purposes. We account for this investment under the fair value option. Changes in fair value are reported through our consolidated statements of income (loss) through market valuation adjustments, net. Interest income is reported through our consolidated statements of income (loss) through interest income, other investments.

See *Note 9* for further discussion on other investments.

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**Cash and Cash Equivalents**

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less. At June 30, 2010, we had minimal concentrations of credit risk arising from cash deposits as more than 97% of our cash and cash equivalents were invested in U.S. Government Treasury Bills or FDIC-insured bank products.

**Restricted Cash**

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities, and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization entities or in the Fund prior to the purchase of loans or securities, payments on or redemption of outstanding ABS issued, or distributions to limited partners. At June 30, 2010, we did not have any significant concentrations of credit risk arising from restricted cash deposits as more than 98% of our restricted cash was held in custodial accounts, invested in U.S. Government Treasury Bills, or held in FDIC-insured bank products.

**Accrued Interest Receivable**

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

**Derivative Financial Instruments**

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



Changes in fair value of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income (loss) through market valuation adjustments, net.

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

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

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**Interest Rate Agreements**

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

**Other Hedging Instruments**

Other hedging instruments we currently utilize include To Be Announced (TBA) contracts, which are forward commitments to purchase agency mortgage-backed securities to be issued in the future. We enter into TBA commitments to offset to varying degrees changes in the value of mortgage products in which we have exposure.

**Credit Derivatives**

Credit derivatives we currently utilize include credit default swaps (CDS), which are agreements to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. These instruments enable us, or our consolidated securitization entities, to synthetically assume the credit risk of a reference security or index of securities. The estimated fair values of these contracts fluctuate for a variety of reasons, such as the likelihood or occurrence of a qualifying credit event (e.g., an interest shortfall, a failure to pay principal, or a distressed rating downgrade), the market perception of default risk and counterparty risk, and supply and demand changes.

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

**Deferred Tax Assets**

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

this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is reduced.

### **Deferred Asset-Backed Securities Issuance Costs**

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

### **Other Assets**

Other assets include real estate owned (REO), fixed assets, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair value. Subsequent declines in the value of an REO property are recorded in our consolidated statements of income (loss) as a component of market valuation adjustments, net. All other assets are reported at cost.

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

**Short-Term Debt**

Short-term debt can include master repurchase agreements, bank borrowings, and other forms of collateralized borrowings with various commercial banks and investment banks that expire within one year. These facilities may be unsecured or collateralized by loans or securities. In the second quarter of 2010, we incurred short-term debt and intend to use short-term debt as we accumulate loans in the future. We had no short-term debt outstanding at June 30, 2010.

**Accrued Interest Payable**

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

**Asset Backed Securities Issued    Sequoia and Acacia**

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote securitization entities sponsored by Redwood. Sequoia and Acacia assets are held in the custody of trustees. 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 obligations are payable solely from the assets of these entities and are not obligations of Redwood.

**Sequoia ABS Issued**

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

## **Acacia ABS Issued**

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

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

## **Long-Term Debt**

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

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

## **Equity**

### **Earnings (Loss) Per Common Share**

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

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On January 1, 2009, we adopted new accounting guidance on EPS that defines unvested share-based payment awards that contain nonforfeitable rights to dividends as participating securities that are included in computing EPS using the two-class method. The two-class method is an earnings allocation formula under which EPS is calculated for common stock and participating securities according to dividends declared and participating rights in undistributed earnings. Under this method, all earnings (distributed and undistributed) are allocated to participating securities and common shares based on their respective rights to receive dividends. Our adoption of this guidance required us to recast previously reported EPS and did not have a significant impact on EPS.

**Other Comprehensive Income (Loss)**

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

**Noncontrolling Interest**

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

**Equity Compensation Plans**

**Incentive Plan**

In May 2010, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided for an increase in the number of shares available for distribution under the plan. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock

options (ISOs), non-qualifying stock options (NQSOs), deferred stock units (DSUs), restricted stock, performance shares, performance units (including cash), stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

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

### **Employee Stock Purchase Plan**

In May 2009, our stockholders approved an amendment to our 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP), to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in Redwood through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at

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85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter.

**Executive Deferred Compensation Plan**

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

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

**Taxes**

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

See *Note 18* for further discussion on taxes.

**Recent Accounting Pronouncements**

In April 2010, the FASB issued Accounting Standards Update (ASU) 2010-18, *Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset* a consensus of the FASB Emerging Issues Task Force, to clarify the accounting for loan modifications when the loan is part of a pool of loans that is accounted for as a single asset. The new guidance provides that modification of such loans that are accounted for within a pool does not result in the removal of those loans from the pool even if the modification of those loans would otherwise be



considered a troubled debt restructuring. The entity would continue to consider whether such pool of assets is impaired if the expected cash flows for the pool change. The amended guidance does not affect the accounting for loans that are not accounted for within pools. Loans accounted for individually continue to be accounted for under the troubled debt restructuring guidance. In addition, the amended guidance allows entities to make a one-time election to terminate accounting for loans in a pool. The amended guidance is effective for a modification of a loan(s) accounted for within a pool occurring in the first interim or annual period ending on or after July 15, 2010. The amended guidance must be applied prospectively, and early application is permitted. We are currently evaluating the impact of ASU 2010-18 on our consolidated financial statements.

In July 2010, the FASB issued Accounting Standards Update (ASU) 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which amends ASC 310 by requiring more robust and disaggregated disclosures about the credit quality of an entity's financing receivables and its allowance for credit losses. The objective of enhancing these disclosures is to improve financial statement users' understanding of (1) the nature of an entity's credit risk associated with its financing receivables and (2) the entity's assessment of that risk in estimating its allowance for credit losses as well as changes in the allowance and the reasons for those changes. ASU 2010-20 requires disclosures of the portfolio

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segment and class of financing receivable levels, and focuses on the following: nonaccrual and past due financing receivables, allowance for credit losses related to financing receivables, impaired loans (individually evaluated for impairment), credit quality information, and modification. The amended guidance is effective for public companies in the first interim or annual period ending on or after December 31, 2010. ASU 2010-20 will increase our loan and allowance for loan loss disclosures, but will not have an effect on our consolidated financial statements.

**Note 4. Principles of Consolidation**

We apply ASC 860 and ASC 810-10 to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. ASC 860 considers whether securitizations and other transfers of financial assets are treated as sales or financings. Additionally, ASC 810-10 addresses whether VIEs (e.g., certain legal entities often used in securitization and other structured finance transactions) should be included in the consolidated financial statements of any particular interested party. These standards became effective for our interests in all VIEs as of January 1, 2010, except for the Fund as a result of the FASB's decision to delay the applicability of ASC 810-10 for private equity funds. Our determination of whether we must consolidate the Fund was performed in accordance with FASB Interpretation No. 46 (revised), *Consolidation of Variable Interest Entities* (FIN 46(R)), at the time we acquired our interests in the Fund.

**Analysis of Consolidated VIEs**

The VIEs we are required to consolidate include the Fund, certain Sequoia securitization entities, and the Acacia entities. The following table presents a summary of the assets and liabilities of these VIEs.

**Assets and Liabilities of Consolidated VIEs at June 30, 2010**

| (Dollars in thousands) | The Fund | Sequoia<br>Entities | Acacia<br>Entities | Total        |
|------------------------|----------|---------------------|--------------------|--------------|
| Real estate loans      | \$       | \$ 3,788,024        | \$ 19,485          | \$ 3,807,509 |
| Real estate securities | 25,080   |                     | 257,530            | 282,610      |
| Other investments      |          |                     | 3,654              | 3,654        |
| Other assets           | 2,428    | 23,882              | 32,993             | 59,303       |

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|                         |           |              |            |              |
|-------------------------|-----------|--------------|------------|--------------|
| Total Assets            | \$ 27,508 | \$ 3,811,906 | \$ 313,662 | \$ 4,153,076 |
| Asset-backed securities | \$        | \$ 3,708,395 | \$ 253,104 | \$ 3,961,499 |
| Other liabilities       | 806       | 2,892        | 84,491     | 88,189       |
| Total Liabilities       | \$ 806    | \$ 3,711,287 | \$ 337,595 | \$ 4,049,688 |
| Noncontrolling Interest | \$ 11,993 | \$           | \$         | \$ 11,993    |
| Number of VIEs          | 1         | 37           | 10         | 48           |

We determined that we are the primary beneficiary of the Fund as our ongoing asset management responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of the Fund, and our significant general and limited partnership interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

We consolidate the assets and liabilities of certain Sequoia securitization entities issued prior to 2010, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Had we not been the transferor and depositor of these securitizations, we would likely not have consolidated them as we determined that we are not the primary beneficiary of these entities in accordance with ASC 810-10.

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In April 2010, we sponsored a \$238 million residential prime jumbo mortgage securitization through our Sequoia program and recorded the assets and liabilities of this entity on our consolidated balance sheet, as we did not meet the sale criteria at the time we transferred financial assets to this entity. We determined that we are the primary beneficiary of this Sequoia entity as our ongoing loss mitigation and resolution responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of the entity and our significant investment interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

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

**Analysis of Non-Consolidated VIEs**

Third party VIEs are securitization entities that Redwood did not sponsor. We may own several securities from a third party VIE, and in those cases, the analysis is done in consideration of all of our interests in that VIE. We determined that we are not the primary beneficiary of any third-party residential, commercial, re-REMIC, or CDO entities in any third party VIEs, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise 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 VIEs we only account for our specific interests in each.

The following table presents a summary of Redwood's interest in third party VIEs at June 30, 2010, grouped by collateral type and ownership interest.

**VIE Summary**

| June 30, 2010<br>(Dollars in Thousands) | Fair Value | Number of<br>VIEs |
|---|------------|-------------------|
| Real estate securities at Redwood       |            |                   |
| Residential                             |            |                   |
| Senior                                  | \$ 630,099 | 99                |

|  |            |     |
|--|------------|-----|
| Re-REMIC                                 | 69,070     | 10  |
| Subordinate                              | 26,436     | 203 |
| Commercial                               | 7,610      | 15  |
| CDO                                      | 1,132      | 10  |
| Total Third-party Real Estate Securities | \$ 734,347 | 337 |

Our future assessments of whether we are required to consolidate a VIE may change based upon the facts and circumstances pertaining to each VIE. Changes in accounting for any VIE could result in a material impact to our financial statements in subsequent reporting periods.

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

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

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 as of June 30, 2010 and December 31, 2009.

| (In Thousands)                          | June 30, 2010  |              | December 31, 2009 |              |
|---|----------------|--------------|-------------------|--------------|
|   | Carrying Value | Fair Value   | Carrying Value    | Fair Value   |
| Assets                                  |                |              |                   |              |
| Real estate loans (held-for-investment) | \$ 3,788,266   | \$ 3,112,660 | \$ 3,724,791      | \$ 3,000,496 |
| Real estate loans (held-for-sale)       | 2,404          | 2,404        | 2,374             | 2,374        |
| Real estate loans (fair value)          | 19,485         | 19,485       | 12,089            | 12,089       |
| Trading securities                      | 275,994        | 275,994      | 277,274           | 277,274      |
| Available-for-sale securities           | 740,963        | 740,963      | 810,471           | 810,471      |
| Other investments                       | 3,654          | 3,654        | 20,371            | 20,371       |
| Cash and equivalents                    | 288,376        | 288,376      | 242,818           | 242,818      |
| Derivative assets                       | 4,735          | 4,735        | 12,372            | 12,372       |
| Restricted cash                         | 26,814         | 26,814       | 94,306            | 94,306       |
| Accrued interest receivable             | 14,085         | 14,085       | 18,193            | 18,193       |
| REO (included in other assets)          | 11,797         | 11,797       | 17,421            | 17,421       |

|                          |           |           |           |           |
|--------------------------|-----------|-----------|-----------|-----------|
| Liabilities              |           |           |           |           |
| Derivative liabilities   | 106,355   | 106,355   | 83,800    | 83,800    |
| Accrued interest payable | 6,315     | 6,315     | 5,968     | 5,968     |
| ABS Issued               |           |           |           |           |
| ABS issued Sequoia       | 3,681,622 | 3,016,105 | 3,644,933 | 2,909,032 |
| ABS issued Acacia        | 253,104   | 253,104   | 297,596   | 297,596   |
| Total ABS issued         | 3,934,726 | 3,269,209 | 3,942,529 | 3,206,628 |
| Long-term debt           | 140,000   | 61,600    | 140,000   | 68,600    |

We did not elect the fair value option for any residential securities that we acquired in the second quarter of 2010.

During the first quarter of 2010, we elected the fair value option for \$13 million of residential senior securities acquired during the quarter. During 2009, we elected the fair value option for certain ABS issued by Sequoia and acquired by Acacia as a result of the deconsolidation of certain Sequoia entities during the fourth quarter of 2008 and second quarter of 2009. These ABS issued had been previously eliminated as intercompany assets for financial reporting purposes.

TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

During 2008, we elected the fair value option for all of the loans, securities, and ABS issued at Acacia. At June 30, 2010, the loans had an aggregate fair value of \$19 million and an unpaid principal balance of \$23 million, the securities had an aggregate fair value of \$258 million and an unpaid principal balance of \$1.9 billion, and the asset-backed securities issued had an aggregate fair value of \$253 million and an unpaid principal balance of \$3.0 billion.

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

**Assets and Liabilities Measured at Fair Value on a Recurring Basis as of June 30, 2010**

| (In Thousands)                | Carrying Value | Fair Value Measurements Using |         |           |
|-------------------------------|----------------|-------------------------------|---------|-----------|
|                               |                | Level 1                       | Level 2 | Level 3   |
| <b>Assets</b>                 |                |                               |         |           |
| Real estate loans             | \$ 19,485      | \$                            | \$      | \$ 19,485 |
| Trading securities            | 275,994        |                               |         | 275,994   |
| Available-for-sale securities | 740,963        |                               |         | 740,963   |
| Other investments             | 3,654          |                               | 3,654   |           |
| Derivative assets             | 4,735          |                               | 4,701   | 34        |
| <b>Liabilities</b>            |                |                               |         |           |
| ABS issued Acacia             | 253,104        |                               |         | 253,104   |
| Derivative liabilities        | 106,355        | 508                           | 102,214 | 3,633     |

**Assets and Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2009**

| (In Thousands)     | Carrying Value | Fair Value Measurements Using |         |           |
|--------------------|----------------|-------------------------------|---------|-----------|
|                    |                | Level 1                       | Level 2 | Level 3   |
| <b>Assets</b>      |                |                               |         |           |
| Real estate loans  | \$ 12,089      | \$                            | \$      | \$ 12,089 |
| Trading securities | 277,274        |                               |         | 277,274   |



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|                               |         |        |         |
|-------------------------------|---------|--------|---------|
| Available-for-sale securities | 810,471 |        | 810,471 |
| Other investments             | 20,371  | 20,371 |         |
| Derivative assets             | 12,372  | 12,326 | 46      |
| Liabilities                   |         |        |         |
| ABS issued Acacia             | 297,596 |        | 297,596 |
| Derivative liabilities        | 83,800  | 63,499 | 20,301  |

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TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

The following table presents additional information about Level 3 assets and liabilities during the six months ended June 30, 2010.

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

| (In Thousands)                    |                   | Assets            |                    |                | Liabilities       |                   |                        |
|-----------------------------------|-------------------|-------------------|--------------------|----------------|-------------------|-------------------|------------------------|
|                                   |                   | Real Estate Loans | Trading Securities | AFS Securities | Derivative Assets | ABS Issued Acacia | Derivative Liabilities |
| Beginning balance                 | December 31, 2009 | \$12,089          | \$277,274          | \$810,471      | \$ 46             | \$297,596         | \$20,301               |
| Principal paydowns                |                   | 52                | (31,102 )          | (71,083 )      |                   | (43,743 )         |                        |
| Gains (losses) in net income, net |                   | 7,344             | 18,479             | 15,290         | (5 )              | (6,004 )          | (262 )                 |
| Gains (losses) in OCI, net        |                   |                   |                    | (5,485 )       |                   |                   |                        |
| Acquisitions                      |                   |                   | 17,137             | 186,057        |                   |                   |                        |
| Sales                             |                   |                   | (6,119 )           | (194,337)      |                   |                   |                        |
| Other settlements, net            |                   |                   | 325                | 50             | (7 )              | 5,255             | (16,406)               |
| Ending Balance                    | June 30, 2010     | \$19,485          | \$275,994          | \$740,963      | \$ 34             | \$253,104         | \$3,633                |

The following table presents the portion of gains or losses included in our consolidated statement of income (loss) that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and still held at June 30, 2010 and 2009. Gains or losses incurred on assets or liabilities sold or otherwise disposed of during the three and six months ended June 30, 2010 and 2009 are not included in this presentation.

**Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2010 and 2009 Included in Net Income (Loss)**

| (In Thousands) | Included in Net Income (Loss)    |      |                                |      |
|----------------|----------------------------------|------|--------------------------------|------|
|                | Three Months Ended June 30, 2010 | 2009 | Six Months Ended June 30, 2010 | 2009 |
| Assets         |                                  |      |                                |      |

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|                               |          |             |          |             |
|-------------------------------|----------|-------------|----------|-------------|
| Real estate loans             | \$ 2,978 | \$ (1,720 ) | \$ 7,344 | \$ (3,967 ) |
| Trading securities            | 5,042    | 11,368      | 17,364   | (34,408 )   |
| Available-for-sale securities | (4,216 ) | (33,237 )   | (6,134 ) | (62,121 )   |
| Derivative assets             | 15       | 71          | (5 )     | 231         |
| Liabilities                   |          |             |          |             |
| ABS issued Acacia             | 11,257   | (28,792 )   | 6,004    | 2,897       |
| Derivative liabilities        | 49       | (401 )      | 109      | (672 )      |

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TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

The following table presents information on assets and liabilities recorded at fair value on a non-recurring basis at June 30, 2010 and December 31, 2009.

**Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of  
June 30, 2010**

| (In Thousands)                    | Carrying<br>Value | Fair Value Measurements<br>Using |         |          | Gain (Loss)                                  |   |
|-----------------------------------|-------------------|----------------------------------|---------|----------|--|---|
|                                   |                   | Level<br>1                       | Level 2 | Level 3  | Three<br>Months<br>Ended June<br>30,<br>2010 | Six Months<br>Ended June<br>30,<br>2010 |
| Assets                            |                   |                                  |         |          |  |   |
| Real estate loans (held-for-sale) | \$ 2,404          | \$                               | \$      | \$ 2,404 | \$ 296                                       | \$ 176                                  |
| REO                               | 11,797            |                                  |         | 11,797   | (1,285 )                                     | (1,359 )                                |

**Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of  
December 31, 2009**

| (In Thousands)                    | Carrying<br>Value | Fair Value Measurements<br>Using |         |          | Gain (Loss)                                  |   |
|-----------------------------------|-------------------|----------------------------------|---------|----------|--|---|
|                                   |                   | Level<br>1                       | Level 2 | Level 3  | Three<br>Months<br>Ended June<br>30,<br>2009 | Six Months<br>Ended June<br>30,<br>2009 |
| Assets                            |                   |                                  |         |          |  |   |
| Real estate loans (held-for-sale) | \$ 2,374          | \$                               | \$      | \$ 2,374 | \$ (56 )                                     | \$ (77 )                                |
| REO                               | 17,421            |                                  |         | 17,421   | (1,159 )                                     | (1,923 )                                |

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income (loss) for the three and six months ended June 30, 2010 and 2009.

**Market Valuation Adjustments, Net**

| (In Thousands)                           | Three Months Ended June 30, |                     | Six Months Ended June 30, |                     |
|--|-----------------------------|---------------------|---------------------------|---------------------|
|  | 2010                        | 2009                | 2010                      | 2009                |
| <b>Assets</b>                            |                             |                     |                           |                     |
| Real estate loans (fair value)           | \$ 2,978                    | \$ (1,720 )         | \$ 7,344                  | \$ (3,967 )         |
| Real estate loans (held-for-sale)        | 296                         | (56 )               | 176                       | (77 )               |
| REO                                      | (1,285 )                    | (1,159 )            | (1,359 )                  | (1,923 )            |
| Trading securities                       | 6,330                       | 11,240              | 18,479                    | (35,185 )           |
| Impairments on AFS securities            | (4,216 )                    | (33,237 )           | (6,162 )                  | (62,272 )           |
| <b>Liabilities</b>                       |                             |                     |                           |                     |
| ABS issued Acacia                        | 11,257                      | (28,792 )           | 6,004                     | 2,897               |
| Derivative instruments, net              | (22,485 )                   | 24,589              | (42,844 )                 | 28,148              |
| <b>Market Valuation Adjustments, Net</b> | <b>\$ (7,125 )</b>          | <b>\$ (29,135 )</b> | <b>\$ (18,362 )</b>       | <b>\$ (72,379 )</b> |

A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed below.

**Real estate loans**

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

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

Real estate securities

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

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. The availability of third-party marks continues to decline, in part because some dealers no longer exist and others have ceased providing client valuation services. For June 30, 2010, we received dealer marks on 78% of our securities. In the aggregate, our internal valuations of the securities on which we received dealer marks were 3% lower (i.e., more conservative) than the aggregate dealer marks.

Other investments

Other investments currently include a GIC. Management considers the GIC's fair value to approximate its contract value, as the GIC earns a variable interest rate of LIBOR less 5 basis points and resets on a monthly basis (Level 2).

Derivative assets and liabilities

Our derivative instruments include interest rate agreements, TBAs, and credit default swaps. Fair values of derivative instruments are determined using quoted prices from active markets when available or valuation models and are verified by valuations provided by dealers active in derivative markets. TBA fair values are generally obtained using quoted prices from active markets (Level 1). Valuation models require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of such inputs. Model inputs for interest rate agreements can generally be verified and model selection does not involve significant management judgment (Level 2). For other derivatives, such as certain CDS, valuations are based on various factors such as liquidity, bid/offer spreads, and credit considerations for which we rely on available market evidence. In the absence of such evidence, management's best estimate is used (Level 3).

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

Short-term debt

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

ABS issued

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

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. The availability of third-party marks continues to decline, in part because some dealers no longer exist and others have ceased providing client valuation services. For June 30, 2010, we received dealer marks on 88% of our ABS issued. Our internal valuations of our ABS issued on which we received dealer marks were 7% higher (i.e., more conservative) than the aggregate dealer marks.

Long-term debt

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

Real Estate Owned (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).

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June 30, 2010  
(Unaudited)****Note 6. Real Estate Loans**

We invest in residential and commercial real estate loans that we acquire from third party originators. We finance these loans through the Sequoia and Acacia entities that we sponsor or with equity or long-term debt.

The following table summarizes the classifications and carrying value of the residential and commercial real estate loans recorded on our consolidated balance sheets at June 30, 2010 and December 31, 2009.

| (In Thousands)                                      | June 30,<br>2010 | December<br>31,<br>2009 |
|---|------------------|-------------------------|
| Residential real estate loans (held-for-sale)       | \$ 2,404         | \$ 2,374                |
| Residential real estate loans (held-for-investment) | 3,788,024        | 3,724,546               |
| Commercial real estate loans (fair value)           | 19,485           | 12,089                  |
| Commercial real estate loans (held-for-investment)  | 242              | 245                     |
| Total Real Estate Loans                             | \$ 3,810,155     | \$ 3,739,254            |

**Residential Real Estate Loans Held-for-Sale**

Residential real estate loans held-for-sale are owned at Redwood and financed with equity. At June 30, 2010, there were 13 residential loans held-for-sale with \$4 million in outstanding principal value and a lower of cost or fair value of \$2 million. At December 31, 2009, there were 14 residential loans held-for-sale with \$4 million in outstanding principal value and a lower of cost or fair value of \$2 million.

**Residential Real Estate Loans Held-for-Investment**

Residential real estate loans held-for-investment are owned at the consolidated Sequoia securitization entities.

The following table provides additional information on residential real estate loans held-for-investment at June 30, 2010 and December 31, 2009.

| (In Thousands)           | June 30,<br>2010 | December<br>31,<br>2009 |
|--------------------------|------------------|-------------------------|
| Principal value          | \$ 3,803,592     | \$ 3,728,738            |
| Unamortized premium, net | 45,910           | 50,028                  |

|                           |             |             |
|---------------------------|-------------|-------------|
| Allowance for loan losses | (61,478 )   | (54,220 )   |
| Carrying Value            | \$3,788,024 | \$3,724,546 |

In April 2010, we sponsored a residential prime jumbo mortgage securitization through our Sequoia program. At June 30, 2010 the loans owned by this Sequoia entity had an outstanding principal value of \$226 million.

Of the \$3.8 billion of principal and \$46 million of unamortized premium on loans held-for-investment at June 30, 2010, \$1.8 billion of principal and \$30 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. During the first half of 2010, 4% of these residential loans prepaid and we amortized 9% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal was \$2 billion and the unamortized premium was \$16 million. During the first half of 2010, 4% of these loans prepaid and we amortized 8% of the premium.

Of the \$3.7 billion of principal and \$50 million of unamortized premium on these loans at December 31, 2009, \$1.8 billion of principal and \$33 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal face was \$1.9 billion and the unamortized premium was \$17 million. During the fourth quarter of 2009, 2% of these loans prepaid and we amortized 4% of the premium.

TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 6. Real Estate Loans (continued)****Commercial Real Estate Loans at Fair Value**

Commercial real estate loans at fair value are owned at the consolidated Acacia securitization entities. At June 30, 2010, there were four commercial loans at fair value with an aggregate outstanding principal value of \$23 million and an aggregate fair value of \$19 million, one of which has been delinquent since May 2009 with an outstanding principal balance of \$4 million and a fair value of \$3 million. At December 31, 2009, there were four commercial loans at fair value, with an outstanding principal of \$23 million and a fair value of \$12 million.

**Commercial Real Estate Loans Held-for-Investment**

At June 30, 2010, there was one commercial loan held-for-investment with \$0.5 million in outstanding principal value and a carrying value of \$0.2 million. During the first half of 2010, we charged off a \$10 million commercial mezzanine loan with no impact to our consolidated statements of income (loss), as we had fully reserved for this loan in 2007. At December 31, 2009, there were two commercial loans held-for-investment with \$11 million in outstanding principal value and a carrying value of \$0.2 million.

**Note 7. Allowance for Loan Losses**

We establish an allowance for loan losses on our residential and commercial loans held-for-investment based on our estimate of losses incurred in these loan portfolios.

**Activity in the Allowance for Losses on Residential Loans**

At June 30, 2010 and June 30, 2009, all residential loans classified as held-for-investment were owned by Sequoia entities. The following table summarizes the activity in the allowance for loan losses on residential loans for the three and six months ended June 30, 2010 and 2009.

| (In Thousands)                 | Three Months Ended June 30, |           | Six Months Ended June 30, |           |
|--------------------------------|-----------------------------|-----------|---------------------------|-----------|
|                                | 2010                        | 2009      | 2010                      | 2009      |
| Balance at Beginning of Period | \$ 61,169                   | \$ 47,947 | \$ 54,220                 | \$ 35,713 |
| Charge-offs, net               | (4,012 )                    | (1,820 )  | (6,539 )                  | (5,618 )  |
| Provision for loan losses      | 4,321                       | 14,545    | 13,797                    | 30,577    |

|                            |           |           |           |           |
|----------------------------|-----------|-----------|-----------|-----------|
| Deconsolidation adjustment |           | (14,795 ) |           | (14,795 ) |
| Balance at End of Period   | \$ 61,478 | \$ 45,877 | \$ 61,478 | \$ 45,877 |

Serious delinquencies on consolidated Sequoia loans were \$144 million and \$137 million as of June 30, 2010 and 2009, respectively. Serious delinquencies include loans delinquent more than 90 days and in foreclosure. As a percentage of outstanding loan balances, serious delinquencies were 3.80% and 3.48% at June 30, 2010 and 2009, respectively.

When we pursue foreclosure in full satisfaction for a defaulted loan, we estimate the specific loan loss, if any, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest and other costs), and charge this specific estimated loss against the allowance for loan losses. During the first half of 2010, there were \$7 million of charge-offs that reduced our allowance for loan losses. These charge-offs arose from \$21 million of defaulted loan principal. Foreclosed property is subsequently recorded as REO, a component of other assets.

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June 30, 2010  
(Unaudited)****Note 8. Real Estate Securities**

We invest in third party residential, commercial, and CDO securities. The following table presents the fair values of our real estate securities by collateral type and entity as of June 30, 2010 and December 31, 2009.

| June 30, 2010<br>(In Thousands) | Redwood    | The Fund  | Acacia     | Total<br>Securities |
|---------------------------------|------------|-----------|------------|---------------------|
| Residential                     | \$ 725,605 | \$ 21,135 | \$ 197,167 | \$ 943,907          |
| Commercial                      | 7,610      |           | 48,979     | 56,589              |
| CDO                             | 1,132      | 3,945     | 11,384     | 16,461              |
| Total Real Estate Securities    | \$ 734,347 | \$ 25,080 | \$ 257,530 | \$ 1,016,957        |

| December 31, 2009<br>(In Thousands) | Redwood    | The Fund  | Acacia     | Total<br>Securities |
|-------------------------------------|------------|-----------|------------|---------------------|
| Residential                         | \$ 770,916 | \$ 32,884 | \$ 201,367 | \$ 1,005,167        |
| Commercial                          | 9,200      |           | 54,206     | 63,406              |
| CDO                                 | 1,247      | 4,067     | 13,858     | 19,172              |
| Total Real Estate Securities        | \$ 781,363 | \$ 36,951 | \$ 269,431 | \$ 1,087,745        |

The following table presents our securities by trading and AFS, collateral type, and entity as of June 30, 2010 and December 31, 2009.

| June 30, 2010<br>(In Thousands) | Trading |          |          | AFS        |          |            |
|---------------------------------|---------|----------|----------|------------|----------|------------|
|                                 | Redwood | Acacia   | Total    | Redwood    | The Fund | Total      |
| Senior Securities               |         |          |          |            |          |            |
| Residential prime               | \$      | \$ 4,653 | \$ 4,653 | \$ 309,702 | \$       | \$ 309,702 |
| Residential non-prime           | 16,763  | 100,832  | 117,595  | 303,634    | 15,451   | 319,085    |
| Commercial                      |         | 10,832   | 10,832   |            |          |            |
| Total Senior Securities         | 16,763  | 116,317  | 133,080  | 613,336    | 15,451   | 628,787    |
| Re-REMIC Securities             |         |          |          | 69,070     |          | 69,070     |
| Subordinate Securities          |         |          |          |            |          |            |
| Residential prime               | 381     | 23,415   | 23,796   | 16,025     |          | 16,025     |
| Residential non-prime           | 188     | 68,267   | 68,455   | 9,842      | 5,684    | 15,526     |
| Commercial                      |         | 38,147   | 38,147   | 7,610      |          | 7,610      |
| CDO                             | 1,132   | 11,384   | 12,516   |            | 3,945    | 3,945      |

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|                              |           |            |            |            |           |            |
|------------------------------|-----------|------------|------------|------------|-----------|------------|
| Total Subordinate Securities | 1,701     | 141,213    | 142,914    | 33,477     | 9,629     | 43,106     |
| Total Real Estate Securities | \$ 18,464 | \$ 257,530 | \$ 275,994 | \$ 715,883 | \$ 25,080 | \$ 740,963 |

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June 30, 2010  
(Unaudited)****Note 8. Real Estate Securities (continued)**

| December 31, 2009<br>(In Thousands) | Trading  |            |            | AFS        |           |            |
|-------------------------------------|----------|------------|------------|------------|-----------|------------|
|                                     | Redwood  | Acacia     | Total      | Redwood    | The Fund  | Total      |
| Senior Securities                   |          |            |            |            |           |            |
| Residential prime                   | \$       | \$ 4,826   | \$ 4,826   | \$ 329,208 | \$        | \$ 329,208 |
| Residential non-prime               | 6,084    | 100,397    | 106,481    | 308,868    | 26,735    | 335,603    |
| Commercial                          |          | 9,508      | 9,508      |            |           |            |
| Total Senior Securities             | 6,084    | 114,731    | 120,815    | 638,076    | 26,735    | 664,811    |
| Re-REMIC Securities                 |          |            |            | 105,951    |           | 105,951    |
| Subordinate Securities              |          |            |            |            |           |            |
| Residential prime                   | 319      | 27,380     | 27,699     | 19,191     |           | 19,191     |
| Residential non-prime               | 218      | 68,764     | 68,982     | 1,077      | 6,149     | 7,226      |
| Commercial                          |          | 44,698     | 44,698     | 9,200      |           | 9,200      |
| CDO                                 | 1,222    | 13,858     | 15,080     | 25         | 4,067     | 4,092      |
| Total Subordinate Securities        | 1,759    | 154,700    | 156,459    | 29,493     | 10,216    | 39,709     |
| Total Real Estate Securities        | \$ 7,843 | \$ 269,431 | \$ 277,274 | \$ 773,520 | \$ 36,951 | \$ 810,471 |

Senior securities are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests. Prime residential securities are securities backed by prime residential loans that generally have low loan-to-value ratios (typically 75% LTV or less), are made to borrowers who have high FICO scores (typically 700 or higher), and typically have low concentrations of investor properties. Non-prime residential securities are generally backed by loans that have higher loan-to-value ratios, are made to borrowers who have lower credit scores or impaired credit histories (but exhibit the ability to repay their loans), and may have higher concentrations of investor properties. At June 30, 2010, all of our real estate securities had contractual maturities over ten years, except for less than \$1 million of residential securities that had contractual maturities greater than five years but less than ten years.

**AFS Securities**

We generally purchase AFS securities at a discount. To the extent we purchase an AFS security that has a likelihood of incurring credit loss, we generally will not amortize into income the portion of the purchase discount that, although we are entitled to earn, we do not expect to collect due to the inherent credit risk of the security. We may also expense a portion of our investment in the security to the extent we believe that principal losses will exceed the purchase

discount. We designate the amount of principal face that we do not expect to receive and will not amortize into income as a credit reserve on the security, with any remaining net unamortized discounts or premiums amortized into income over time using the interest method.



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June 30, 2010  
(Unaudited)****Note 8. Real Estate Securities (continued)**

The following table presents the components of carrying value (which equals fair value) of AFS securities as of June 30, 2010 and December 31, 2009.

| June 30, 2010<br>(In Thousands)     | Residential  | Commercial | CDO       | Total        |
|-------------------------------------|--------------|------------|-----------|--------------|
| Current face                        | \$ 1,284,102 | \$ 140,547 | \$ 89,422 | \$ 1,514,071 |
| Credit reserve                      | (327,636 )   | (127,627 ) | (88,340 ) | (543,603 )   |
| Net unamortized (discount) premium  | (310,131 )   | (5,534 )   | 10,929    | (304,736 )   |
| Amortized cost                      | 646,335      | 7,386      | 12,011    | 665,732      |
| Gross unrealized gains              | 109,218      | 1,509      |           | 110,727      |
| Gross unrealized losses             | (26,145 )    | (1,285 )   | (8,066 )  | (35,496 )    |
| Carrying Value                      | \$ 729,408   | \$ 7,610   | \$ 3,945  | \$ 740,963   |
| <br>                                |              |            |           |              |
| December 31, 2009<br>(In Thousands) | Residential  | Commercial | CDO       | Total        |
| Current face                        | \$ 1,581,692 | \$ 158,997 | \$ 89,371 | \$ 1,830,060 |
| Credit reserve                      | (469,273 )   | (146,018 ) | (87,017 ) | (702,308 )   |
| Net unamortized (discount) premium  | (401,808 )   | (5,130 )   | 8,941     | (397,997 )   |
| Amortized cost                      | 710,611      | 7,849      | 11,295    | 729,755      |
| Gross unrealized gains              | 130,914      | 1,422      | 25        | 132,361      |
| Gross unrealized losses             | (44,346 )    | (71 )      | (7,228 )  | (51,645 )    |
| Carrying Value                      | \$ 797,179   | \$ 9,200   | \$ 4,092  | \$ 810,471   |

The following table presents the changes for the three and six months ended June 30, 2010 of the unamortized discount and designated credit reserves on AFS securities.

**Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities****Three Months Ended June 30, 2010**

| Residential | Commercial | CDO |
|-------------|------------|-----|
|-------------|------------|-----|

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| (In Thousands)                            |                | Credit Reserve | Unamortized Discount Net | Credit Reserve | Unamortized Discount Net | Credit Reserve | Unamortized Discount Net |
|---|----------------|----------------|--------------------------|----------------|--------------------------|----------------|--------------------------|
| Beginning balance                         | March 31, 2010 | \$388,078      | \$355,194                | \$139,320      | \$5,660                  | \$87,103       | \$(9,379)                |
| Amortization of net discount              |                |                | (10,478)                 |                | (31)                     |                | (313)                    |
| Realized credit losses                    |                | (56,685)       |                          | (11,860)       |                          |                |                          |
| Acquisitions                              |                | 2,142          | 9,190                    |                |                          |                |                          |
| Sales, calls, other                       |                | (12,273)       | (41,545)                 |                |                          |                |                          |
| Impairments                               |                | 4,144          |                          | 72             |                          |                |                          |
| Transfers to (release of) credit reserves |                | 2,230          | (2,230)                  | 95             | (95)                     | 1,237          | (1,237)                  |
| Ending Balance                            | June 30, 2010  | \$327,636      | \$310,131                | \$127,627      | \$5,534                  | \$88,340       | \$(10,929)               |

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June 30, 2010  
(Unaudited)****Note 8. Real Estate Securities (continued)****Six Months Ended June 30, 2010**

| (In Thousands)                            |                   | Residential    |                          | Commercial     |                          | CDO            |                          |
|---|-------------------|----------------|--------------------------|----------------|--------------------------|----------------|--------------------------|
|   |                   | Credit Reserve | Unamortized Discount Net | Credit Reserve | Unamortized Discount Net | Credit Reserve | Unamortized Discount Net |
| Beginning balance                         | December 31, 2009 | \$469,273      | \$401,808                | \$146,018      | \$5,130                  | \$87,017       | \$(8,941)                |
| Amortization of net (discount) premium    |                   |                | (21,074)                 |                | 288                      |                | (665)                    |
| Realized credit losses                    |                   | (99,879)       |                          | (18,450)       |                          |                |                          |
| Acquisitions                              |                   | 11,108         | 52,578                   |                |                          |                |                          |
| Sales, calls, other                       |                   | (64,608)       | (117,426)                |                |                          |                |                          |
| Impairments                               |                   | 5,987          |                          | 175            |                          |                |                          |
| Transfers to (release of) credit reserves |                   | 5,755          | (5,755)                  | (116)          | 116                      | 1,323          | (1,323)                  |
| Ending Balance                            | June 30, 2010     | \$327,636      | \$310,131                | \$127,627      | \$5,534                  | \$88,340       | \$(10,929)               |

The loans underlying our residential subordinate securities totaled \$55 billion at June 30, 2010. These loans are located nationwide with a large concentration in California (46%). Serious delinquencies (90+ days, in foreclosure or REO) at June 30, 2010 were 8.02% of current principal balances. The loans underlying our commercial subordinate securities totaled \$24 billion at June 30, 2010, and consist primarily of office (37%), retail (34%), and multifamily (13%) loans. These loans are located nationwide with the highest concentration in California (15%). Serious delinquencies (60+ days, in foreclosure or REO) at June 30, 2010 were 5.20% of current principal balances.

**AFS Securities with Unrealized Losses**

The following table presents the components comprising the carrying value of AFS securities that were in an unrealized loss position as of June 30, 2010 and December, 31 2009.

Less Than 12 Consecutive Months      12 Consecutive Months or Longer

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| June 30, 2010<br>(In Thousands) | Total<br>Amortized<br>Cost | Gross<br>Unrealized<br>Losses | Total<br>Fair<br>Value | Total<br>Amortized<br>Cost | Gross<br>Unrealized<br>Losses | Total<br>Fair<br>Value |
|---------------------------------|----------------------------|-------------------------------|------------------------|----------------------------|-------------------------------|------------------------|
| Residential                     | \$ 116,299                 | \$ (3,379 )                   | \$ 112,920             | \$ 47,991                  | \$ (22,766 )                  | \$ 25,225              |
| Commercial                      | 4,777                      | (1,285 )                      | 3,492                  |                            |                               |                        |
| CDO                             | 4,395                      | (2,591 )                      | 1,804                  | 7,616                      | (5,475 )                      | 2,141                  |
| Total Securities                | \$ 125,471                 | \$ (7,255 )                   | \$ 118,216             | \$ 55,607                  | \$ (28,241 )                  | \$ 27,366              |

| December 31, 2009<br>(In Thousands) | Less Than 12 Consecutive Months |                               |                        | 12 Consecutive Months or Longer |                               |                        |
|-------------------------------------|---------------------------------|-------------------------------|------------------------|---------------------------------|-------------------------------|------------------------|
|                                     | Total<br>Amortized<br>Cost      | Gross<br>Unrealized<br>Losses | Total<br>Fair<br>Value | Total<br>Amortized<br>Cost      | Gross<br>Unrealized<br>Losses | Total<br>Fair<br>Value |
| Residential                         | \$ 73,075                       | \$ (30,520 )                  | \$ 42,555              | \$ 42,368                       | \$ (13,826 )                  | \$ 28,542              |
| Commercial                          | 2,719                           | (71 )                         | 2,648                  |                                 |                               |                        |
| CDO                                 | 4,091                           | (2,136 )                      | 1,955                  | 7,204                           | (5,092 )                      | 2,112                  |
| Total Securities                    | \$ 79,885                       | \$ (32,727 )                  | \$ 47,158              | \$ 49,572                       | \$ (18,918 )                  | \$ 30,654              |

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June 30, 2010  
(Unaudited)****Note 8. Real Estate Securities (continued)**

At June 30, 2010, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 521 AFS securities, of which 152 were in an unrealized loss position, of which 107 were in a continuous unrealized loss position for twelve consecutive months or longer. At December 31, 2009, our consolidated balance sheet included 554 AFS securities, of which 220 were in a continuous unrealized loss position and 72 were in a continuous unrealized loss position for twelve months or longer.

Of the total unrealized losses at June 30, 2010 and December 31, 2009, \$10 million and \$14 million, respectively, relate to securities owned at the Fund. The remaining unrealized losses relate to securities owned at Redwood.

**Evaluating AFS Securities for Other-than-Temporary Impairments**

When the fair value of an AFS security is below our cost basis, we evaluate the security for other-than-temporary impairment (OTTI). Part of this evaluation is based upon significant adverse changes in the assumptions used to value the security. The table below summarizes the significant valuation assumptions we used for our AFS securities as of June 30, 2010.

**Significant Valuation Assumptions**

| June 30, 2010                   | Range for Securities |     |           |     |            |     |
|---------------------------------|----------------------|-----|-----------|-----|------------|-----|
|                                 | Prime                |     | Non-prime |     | Commercial |     |
| Prepayment rates                | 2                    | 15% | 1         | 12% | N/A        |     |
| Loss severity <sup>(1)</sup>    | 15                   | 68% | 22        | 63% | 33         | 50% |
| Projected losses <sup>(1)</sup> | 0                    | 21% | 1         | 58% | 2          | 14% |

Projected losses and severities are generally vintage specific, with the 2005 and later vintage securities having (1) higher projected losses and severities and the 2004 and earlier vintages having the lower projected losses and severities.

The following table details the components of OTTI for the three and six months ended June 30, 2010. The credit component of OTTI is recognized through our consolidated statement of income (loss) while the non-credit component of OTTI is recorded in accumulated other comprehensive income (loss).

## Components of Other-than-Temporary Impairments

| (In Thousands)                                      | Three<br>Months<br>Ended<br>June 30,<br>2010 | Six Months<br>Ended<br>June 30,<br>2010 |
|---|--|---|
| For securities with a non-credit component of OTTI: |  |   |
| Initial credit impairment                           | \$ 213                                       | \$ 303                                  |
| Subsequent credit impairment                        | 3,143  | 4,439                                   |
| Securities with no non-credit component of OTTI     | 860  | 1,420                                   |
| Total credit OTTI                                   | 4,216  | 6,162                                   |
| Non-credit component of OTTI                        | 2,870  | 4,539                                   |
| Total OTTI  | \$ 7,086                                     | \$ 10,701                               |

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June 30, 2010  
(Unaudited)****Note 8. Real Estate Securities (continued)**

The following table details the activity related to the credit component of OTTI (i.e., OTTI in either current earnings or retained earnings) for AFS securities that also had a non-credit component and were still held at June 30, 2010. The credit loss component is reduced if we sell, intend to sell or believe we will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if we receive or expect to receive cash flows in excess of what we previously expected to receive over the remaining life of the credit-impaired debt security, the security matures, or is fully written down.

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

| (In Thousands)  | Three<br>Months<br>Ended<br>June 30,<br>2010 | Six Months<br>Ended<br>June 30,<br>2010 |
|---|--|---|
| Balance at beginning of period                        | \$ 143,116                                   | \$ 146,454                              |
| Additions <sup>(1)</sup> :                            |  |   |
| Initial credit impairments                            | 213  | 303                                     |
| Subsequent credit impairments                         | 3,143  | 4,439                                   |
| Reductions:   |  |   |
| For securities sold                                   | (5,113 )                                     | (5,113 )                                |
| For securities matured, called, or fully written down | (9,329 )                                     | (14,053 )                               |
| Balance at End of Period                              | \$ 132,030                                   | \$ 132,030                              |

(1) Excludes \$1 million for both the three and six months ended June 30, 2010, of credit related OTTI where there was not a corresponding non-credit component.

**Gross Realized Gains and Losses**

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income (loss). The following table presents the gross realized gains and losses on sales of AFS securities for the three and six months ended June 30, 2010 and 2009.

| Three Months Ended<br>June 30, | Six Months Ended<br>June 30, |
|--------------------------------|------------------------------|
|--------------------------------|------------------------------|

| (In Thousands)                                       | 2010      | 2009     | 2010      | 2009     |
|--|-----------|----------|-----------|----------|
| Gross realized gains sales                           | \$ 17,670 | \$ 6,861 | \$ 56,524 | \$ 7,198 |
| Gross realized losses sales                          | (1,859 )  |          | (3,335 )  |          |
| Total Realized Gains on Sales of AFS Securities, net | \$ 15,811 | \$ 6,861 | \$ 53,189 | \$ 7,198 |

## Note 9. Other Investments

Other investments include a GIC owned by an Acacia securitization entity and recorded on our consolidated balance sheets at its estimated fair value. This GIC represents a deposit certificate issued by a rated investment bank and serves as collateral to cover realized losses on CDS entered into by this same Acacia entity. The CDS reference residential mortgage-backed securities issued in 2006 that were initially A and BBB-rated and have subsequently been downgraded. The fair value of the GIC was \$4 million as of June 30, 2010, which is equal to its carrying value. The GIC has been drawn down by \$76 million since its acquisition to cover credit losses and principal reductions on the referenced securities.



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June 30, 2010  
(Unaudited)****Note 10. Derivative Financial Instruments**

Redwood and the consolidated Acacia entities held derivative financial instruments at June 30, 2010. The derivatives held at Acacia entities are not the obligations of Redwood.

The following table shows the aggregate fair value and notional amount by entity of these derivative financial instruments as of June 30, 2010 and December 31, 2009.

| June 30, 2010<br>(In Thousands)                     | Redwood<br>Fair<br>Value | Notional<br>Amount | Acacia<br>Fair<br>Value | Notional<br>Amount | Total<br>Fair<br>Value | Notional<br>Amount |
|---|--------------------------|--------------------|-------------------------|--------------------|------------------------|--------------------|
| Assets Accounted for as<br>Trading Instruments      |                          |                    |                         |                    |                        |                    |
| Interest rate swaps                                 | \$                       | \$                 | \$922                   | \$51,326           | \$922                  | \$51,326           |
| Interest rate caps purchased                        |                          |                    | 3,813                   | 714,800            | 3,813                  | 714,800            |
| Total Assets  |                          |                    | 4,735                   | 766,126            | 4,735                  | 766,126            |
| Liabilities Accounted for as<br>Cash Flow Hedges    |                          |                    |                         |                    |                        |                    |
| Interest rate swaps                                 | (21,694)                 | 156,000            |                         |                    | (21,694 )              | 156,000            |
| Liabilities Accounted for as<br>Trading Instruments |                          |                    |                         |                    |                        |                    |
| Interest rate swaps                                 | (2,849 )                 | 34,100             | (77,671)                | 725,557            | (80,520 )              | 759,657            |
| TBAs  | (508 )                   | 41,000             |                         |                    | (508 )                 | 41,000             |
| Credit default swaps                                |                          |                    | (3,633 )                | 3,633              | (3,633 )               | 3,633              |
| Total Liabilities                                   | (25,051)                 | 231,100            | (81,304)                | 729,190            | (106,355)              | 960,290            |
| Total Derivative Financial<br>Instruments, net      | \$(25,051)               | \$231,100          | \$(76,569)              | \$1,495,316        | \$(101,620)            | \$1,726,416        |
| December 31, 2009<br>(In Thousands)                 |                          |                    |                         |                    |                        |                    |
| Assets Accounted for as<br>Trading Instruments      |                          |                    |                         |                    |                        |                    |
| Interest rate swaps                                 | \$                       | \$                 | \$738                   | \$73,563           | \$738                  | \$73,563           |
| Interest rate caps purchased                        |                          |                    | 11,634                  | 711,800            | 11,634                 | 711,800            |

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|   |           |           |            |              |            |              |
|---|-----------|-----------|------------|--------------|------------|--------------|
| Total Assets  |           |           | 12,372     | 785,363      | 12,372     | 785,363      |
| Liabilities Accounted for as<br>Trading Instruments |           |           |            |              |            |              |
| Interest rate swaps                                 | (1,597)   | 14,100    | (61,902)   | 784,856      | (63,499)   | 798,956      |
| Credit default swaps                                |           |           | (20,301)   | 20,301       | (20,301)   | 20,301       |
| Total Liabilities                                   | (1,597)   | 14,100    | (82,203)   | 805,157      | (83,800)   | 819,257      |
| Total Derivative Financial<br>Instruments, net      | \$(1,597) | \$ 14,100 | \$(69,831) | \$ 1,590,520 | \$(71,428) | \$ 1,604,620 |

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June 30, 2010  
(Unaudited)****Note 10. Derivative Financial Instruments (continued)****Interest Rate Agreements**

Net valuation adjustments on interest rate agreements classified as trading instruments were negative \$22 million and negative \$43 million for the three and six months ended June 30, 2010, respectively, and positive \$24 million and positive \$27 million for the three and six months ended June 30, 2009, respectively.

To hedge the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities, we entered into interest rate swaps during the first six months of 2010 with an aggregate notional balance of \$156 million at June 30, 2010. We designated these derivatives as cash flow hedges. For the six months ended June 30, 2010, these hedges decreased in value by \$21 million, of which \$1 million was recorded as a component of interest expense and the remaining \$20 million was recorded as a reduction to accumulated other comprehensive income (loss), a component of stockholders' equity.

For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income (loss) was negative \$42 million at June 30, 2010, and negative \$22 million at December 31, 2009.

The following table illustrates the impact on interest income (expense) of our interest rate agreements accounted for as cash flow hedges for the three and six months ended June 30, 2010 and 2009.

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

| (In Thousands)   | Three Months<br>Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|-----------------------------------|-----------|------------------------------|-----------|
|  | 2010                              | 2009      | 2010                         | 2009      |
| Net interest expense on cash flow interest rate agreements     | \$(1,036)                         | \$        | \$(1,036)                    | \$        |
| Realized net expense due to net ineffective portion of hedges  | (26)                              | )         | (26)                         | )         |
| Realized net losses reclassified from other comprehensive loss | (1,051)                           | (1,111)   | (1,546)                      | (2,210)   |
| Total Interest (Expense) Income                                | \$(2,113)                         | \$(1,111) | \$(2,608)                    | \$(2,210) |

## Other Hedging Instruments

To offset to varying degrees changes in the value of mortgage products in which we have exposure, during the three months ended June 30, 2010, we sold TBA contracts with an aggregate notional value of \$41 million and settlements occurring one to three months from the sale date. These derivative contracts are accounted for as trading instruments with all changes in fair value reported in our consolidated statement of income (loss) as a component of market valuation adjustments, net. Net valuation adjustments on these derivatives were negative \$1 million for the three and six months ended June 30, 2010.

## Credit Derivatives

At June 30, 2010, we had one outstanding CDS contract with a fair value of negative \$4 million and a notional amount of \$4 million that was initiated during 2007 by an Acacia securitization entity that we have consolidated for financial reporting purposes. At December 31, 2009, there were four outstanding CDS contracts with a fair value of negative \$20 million and a notional amount of \$20 million at this Acacia securitization entity. At both June 30, 2010 and December, 31 2009, all of our CDS had expiration dates of greater than 15 years and the credit ratings of the reference securities were CCC or lower. During the three and six months ended June 30, 2010, the reference securities underlying our CDS experienced principal losses resulting in \$7 million and \$17 million obligations, respectively.

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June 30, 2010  
(Unaudited)****Note 10. Derivative Financial Instruments (continued)****Counterparty Credit Risk**

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

As of June 30, 2010, Redwood had outstanding derivative agreements with five bank counterparties and Acacia entities had outstanding derivative agreements with seven bank counterparties. As of June 30, 2010, Redwood and the Acacia entities were in compliance with International Swaps and Derivatives Association (ISDA) agreements governing these open derivative positions.

**Note 11. Other Assets**

Other assets as of June 30, 2010 and December 31, 2009, are summarized in the following table.

**Other Assets**

| (In Thousands)                          | June 30,<br>2010 | December<br>31,<br>2009 |
|---|------------------|-------------------------|
| Real estate owned (REO)                 | \$ 11,797        | \$ 17,421               |
| Fixed assets and leasehold improvements | 4,167            | 3,630                   |
| Derivative margin posted, net           | 24,811           | 1,830                   |
| Investment receivable                   | 539              | 667                     |
| Income tax receivables                  | 2,423            | 65                      |
| Prepaid expenses                        | 1,417            | 2,180                   |
| Other                                   | 158              | 349                     |
| Total Other Assets                      | \$ 45,312        | \$ 26,142               |

REO consists of foreclosed properties received in full satisfaction of defaulted real estate loans. The carrying value of REO at June 30, 2010, was \$12 million, of which \$9 million related to transfers into REO during the first half of 2010, offset by \$12 million of REO liquidations, and \$2 million of negative market valuation adjustments. The carrying value of REO as of December 31, 2009, was \$17 million, of which \$29 million related to transfers into REO during 2009, offset by \$24 million of REO liquidations, \$3 million of negative valuation changes, and \$4 million of REO derecognized as a result of our deconsolidation of certain Sequoia entities.

At June 30, 2010, there were 61 REO properties recorded on our balance sheet, of which 59 were owned at Sequoia and two were owned at Redwood. At December 31, 2009, there were 79 REO properties recorded on our balance sheet, of which 78 were owned at Sequoia and one was owned at Redwood. Properties located in Colorado and Nevada accounted for 40% of our REO outstanding at June 30, 2010.

Derivative margin posted, net, was \$25 million at June 30, 2010, resulting from margin calls from our swap counterparties requiring Redwood to post collateral.

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June 30, 2010  
(Unaudited)****Note 12. Asset-Backed Securities Issued**

The Sequoia and Acacia securitization entities that we sponsor issue ABS to acquire assets from us and from third parties. Each series of ABS issued consists of various classes that pay interest on a monthly or quarterly basis.

Substantially all ABS issued pay variable rates of interest, which are indexed to one, three, or six-month LIBOR.

Some ABS issued pay fixed rates of interest or pay hybrid rates, which are fixed rates that subsequently adjust to variable rates. ABS issued also include some interest-only classes with coupons set at a fixed-rate or a fixed spread, or set at a spread to the interest rates earned on the assets less the interest rates paid on the liabilities of a securitization entity.

In April 2010, Redwood securitized \$238 million of loans through our Sequoia program, with approximately \$211 million of ABS issued to third parties.

The components of ABS issued by consolidated securitization entities we sponsor as of June 30, 2010 and December 31, 2009, along with other selected information, are summarized in the following table.

**Asset-Backed Securities Issued**

| (In Thousands)                                      | June 30, 2010  |                |             | December 31, 2009 |                |             |  |
|---|----------------|----------------|-------------|-------------------|----------------|-------------|--|
|   | Sequoia        | Acacia         | Total       | Sequoia           | Acacia         | Total       |  |
| Certificates with principal value                   | \$3,667,087    | \$2,986,492    | \$6,653,579 | \$3,627,952       | \$3,026,307    | \$6,654,259 |  |
| Interest-only certificates                          | 17,148         |                | 17,148      | 19,190            |                | 19,190      |  |
| Unamortized premium                                 | 2,025          |                | 2,025       | 2,371             |                | 2,371       |  |
| Unamortized discount                                | (4,638 )       |                | (4,638 )    | (4,580 )          |                | (4,580 )    |  |
| Fair value adjustment, net                          |                | (2,733,388 )   | (2,733,388) |                   | (2,728,711 )   | (2,728,711) |  |
| Total ABS Issued                                    | \$3,681,622    | \$253,104      | \$3,934,726 | \$3,644,933       | \$297,596      | \$3,942,529 |  |
| Range of weighted average interest rates, by series | 0.53% to 4.49% | 0.79% to 1.25% |             | 0.44% to 4.69%    | 0.70% to 1.13% |             |  |
| Stated maturities                                   | 2024 2047      | 2039 2052      |             | 2024 2047         | 2039 2052      |             |  |
| Number of series                                    | 37             | 10             |             | 36                | 10             |             |  |

The maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of ABS issued will often occur earlier than its stated maturity.

As of June 30, 2010, all of the \$3.9 billion reported value of ABS issued (\$6.7 billion principal value) had contractual maturities of over five years. Amortization of Sequoia deferred ABS issuance costs was less than \$1 million and \$1 million for the three and six months ended June 30, 2010, respectively, and \$1 million for each of the three and six months ended June 30, 2009.

The following table summarizes the accrued interest payable on ABS issued as of June 30, 2010 and December 31, 2009. Interest due on Sequoia ABS issued is settled monthly and interest due on Acacia ABS issued is settled quarterly.

### **Accrued Interest Payable on Asset-Backed Securities Issued**

| (In Thousands)                               | June 30,<br>2010 | December<br>31,<br>2009 |
|--|------------------|-------------------------|
| Sequoia                                      | \$ 2,625         | \$ 2,356                |
| Acacia                                       | 3,067            | 3,002                   |
| Total Accrued Interest Payable on ABS Issued | \$ 5,692         | \$ 5,358                |

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TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 12. Asset-Backed Securities Issued (continued)**

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding as of June 30, 2010 and December 31, 2009.

**Collateral for Asset-Backed Securities Issued**

| (In Thousands)                  | June 30, 2010 |           |             | December 31, 2009 |           |             |
|---------------------------------|---------------|-----------|-------------|-------------------|-----------|-------------|
|                                 | Sequoia       | Acacia    | Total       | Sequoia           | Acacia    | Total       |
| Real estate loans               | \$3,788,024   | \$19,485  | \$3,807,509 | \$3,724,546       | \$12,090  | \$3,736,636 |
| Real estate securities          |               | 284,303   | 284,303     |                   | 303,852   | 303,852     |
| Other investments               |               | 3,654     | 3,654       |                   | 20,371    | 20,371      |
| Real estate owned (REO)         | 11,471        |           | 11,471      | 17,087            |           | 17,087      |
| Restricted cash                 | 282           | 24,201    | 24,483      | 310               | 89,057    | 89,367      |
| Accrued interest receivable     | 6,622         | 3,601     | 10,223      | 6,931             | 4,731     | 11,662      |
| Total Collateral for ABS Issued | \$3,806,399   | \$335,244 | \$4,141,643 | \$3,748,874       | \$430,101 | \$4,178,975 |

**Note 13. Long-Term Debt**

In 2006, we issued \$100 million of trust preferred securities through Redwood Capital Trust I, a wholly-owned Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating coupon rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than January 30, 2037. The weighted average interest rate on our trust preferred securities, including hedging costs, was 6.19% and 4.71%, for the three and six months ended June 30, 2010, and 4.08% and 4.49%, for the three and six months ended June 30 2009, respectively. The earliest optional redemption date without penalty is January 30, 2012.

In 2007, we issued an additional \$50 million of subordinated notes, which require quarterly distributions at a floating interest rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than July 30, 2037. The weighted average interest rate on our subordinated notes was 6.19% and 4.71%, for the three and six months ended June 30, 2010, respectively, and 4.08% and 4.49%, for the three and six months ended June 30, 2009, respectively. The earliest optional redemption date without a penalty is July 30, 2012. In July 2009, we repurchased \$10 million principal amount of this subordinated debt for \$3.4 million and recorded a \$6.6 million gain on extinguishment of debt in realized gains, net, on our consolidated statements of income (loss).

At both June 30, 2010 and December 31, 2009, the accrued interest payable balance on long-term Redwood debt was less than \$1 million. There are no financial covenants associated with our long-term debt.

## **Note 14. Commitments and Contingencies**

### **Lease Commitments**

As of June 30, 2010 we were obligated under non-cancelable operating leases with expiration dates through 2018 for \$11 million. The majority of the future lease obligations relates to a ten-year operating lease for our executive office that expires in 2013 and a lease for additional space that expires in 2018. The total payments required under these leases are recognized as office rent expense on a straight-line basis over the lease terms. Operating lease expense was less than \$1 million for both the six months ended June 30, 2010 and 2009.

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June 30, 2010  
(Unaudited)****Note 14. Commitments and Contingencies (continued)**

The following table presents our future lease commitments as of June 30, 2010.

**Future Lease Commitments by Year**

| (In Thousands)      | June 30,<br>2010 |
|---------------------|------------------|
| 2010 (six months)   | \$ 961           |
| 2011                | 1,857            |
| 2012                | 1,882            |
| 2013                | 1,439            |
| 2014                | 1,132            |
| 2015 and thereafter | 4,120            |
| Total               | \$ 11,391        |

Leasehold improvements for our offices are amortized into expense over the ten-year lease term, expiring in 2013.

The unamortized leasehold improvement balance was \$3 million at both June 30, 2010 and December 31, 2009.

**Loss Contingencies    Litigation**

On December 23, 2009, the Federal Home Loan Bank of Seattle (the "FHLB Seattle") filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against us, our subsidiary, Sequoia Residential Funding, Inc., Morgan Stanley & Co., and Morgan Stanley Capital, Inc., (collectively, the "Defendants"). The FHLB Seattle alleges claims under the Securities Act of Washington, Section 21.20.005, et seq, and seeks to rescind the purchase and sale of a mortgage pass-through certificate (or, Residential Mortgage Backed Security, "RMBS") issued through our Sequoia RMBS platform and purchased by FHLB Seattle. The FHLB Seattle seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys' fees and costs. On January 22, 2010, the Defendants removed the suit to federal court in the Western District of Washington (case number 2:10-cv-00132-RSM). The FHLB Seattle moved to remand the case to state court on March 11, 2010. The District Court has not ruled on the motion to remand. On June 10, 2010, the FHLB Seattle filed an amended complaint in the District Court. The FHLB Seattle alleges that Defendants offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the credit quality of the mortgage loans that backed it. Among other things, the FHLB Seattle alleges that Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. This RMBS

was issued with an original principal amount of approximately \$133 million and, as of July 31, 2010, had a remaining outstanding principal balance of approximately \$31 million. We believe that this claim is without merit and we intend to defend the action vigorously. However, we cannot determine the outcome of this matter at this time or predict the results with certainty; we cannot assure you that this matter will not have a material adverse effect on our results of operations in any future period, and any loss and expense related to this litigation could have a material adverse impact on our consolidated financial statements.

On July 12, 2010, we received two notices of Election to Void Sale of Securities pursuant to Illinois Securities Law, 815 ILCS Section 5/13(A) from the Federal Home Loan Bank of Chicago ( FHLB Chicago ). FHLB Chicago seeks to void its purchase of two RMBS that were issued in 2006 by a securitization trust with respect to which Sequoia Residential Funding, Inc. was the depositor. The notices were addressed to us, to two of our subsidiaries, RWT Holdings, Inc. and Sequoia Residential Funding, Inc.,

TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 14. Commitments and Contingencies (continued)**

to the securitization trust which issued these two RMBS, Sequoia Mortgage Trust 2006-1, as well as to the underwriters of these RMBS and certain other unaffiliated third parties. The notices assert that the recipients of the notices and their controlling persons are jointly and severally liable for the full amount paid for these RMBS by the FHLB Chicago plus interest thereon at the rate stated in these RMBS, less the principal and interest amounts previously received. The first of these two RMBS was issued with an original principal amount of approximately \$105 million and, as of July 31, 2010, had a remaining outstanding principal balance of approximately \$51 million. The second of these two RMBS was issued with an original principal amount of approximately \$379 million and, as of July 31, 2010, had a remaining outstanding principal balance of approximately \$187 million. We believe that these notices and the related demands are without merit and we intend to defend vigorously any action brought to enforce these demands. However, we cannot determine the outcome of this matter at this time or predict the results with certainty; we cannot assure you that this matter will not have a material adverse effect on our results of operations in any future period, and any loss and expense related to this matter, including, without limitation, any litigation relating to this matter, could have a material adverse impact on our consolidated financial statements.

In accordance with FASB guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due.

**Note 15. Equity**

The following table provides a summary of changes to stockholders' equity for the three and six months ended June 30, 2010.

**Stockholders' Equity**

| (In Thousands)                 | Three<br>Months<br>Ended<br>June 30,<br>2010 | Six Months<br>Ended<br>June 30,<br>2010 |
|--------------------------------|--|---|
| Balance at beginning of period | \$ 997,606                                   | \$ 971,721                              |

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|  |            |            |
|--|------------|------------|
| Issuance of new equity capital, net                  | 3,740      | 9,939      |
| Unrealized losses on securities and derivatives, net | (19,398 )  | (26,661 )  |
| Distributions to shareholders                        | (20,014 )  | (39,908 )  |
| Net income attributable to Redwood Trust, Inc.       | 28,601     | 75,444     |
| Balance at End of Period                             | \$ 990,535 | \$ 990,535 |

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TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 15. Equity (continued)****Accumulated Other Comprehensive Income**

The following table provides a summary of the components of accumulated other comprehensive income as of June 30, 2010 and December 31, 2009.

| (In Thousands)  | June 30,<br>2010 | December<br>31,<br>2009 |
|---|------------------|-------------------------|
| Net unrealized gains on real estate securities                                      | \$75,231         | \$80,716                |
| Less: Unrealized losses attributable to noncontrolling interest                     | (4,525 )         | (6,614 )                |
| Net unrealized gains on real estate securities recognized in equity                 | 79,756           | 87,330                  |
| Net unrealized losses on interest rate agreements accounted for as cash flow hedges | (41,557)         | (22,470 )               |
| Total Accumulated Other Comprehensive Income  | \$38,199         | \$64,860                |

At June 30, 2010, the net unrealized gains on AFS securities were \$75 million, a \$6 million decrease from the net unrealized gains of \$81 million at December 31, 2009. During the first six months of 2010, \$5 million of net unrealized losses were reclassified to earnings upon recognition of OTTI, a \$32 million decrease in unrealized gains was recognized on the sale of securities, and \$21 million of fair value increases in securities were recognized in net unrealized gains. A portion of these net unrealized losses, \$5 million at June 30, 2010 and \$7 million at December 31, 2009, were attributable to the noncontrolling interest on AFS securities owned by the Fund.

At June 30, 2010, interest rate agreements, previously or currently accounted for as cash flow hedges, had an unrealized loss of \$42 million. The portion attributable to previously accounted for cash flow hedges (\$20 million), will be expensed through our consolidated statements of income (loss) over the remaining lives of previously designated hedged items (See *Note 10*), which will generally be \$1 million per quarter. The balance associated with the currently accounted for cash flow hedge (\$22 million) will not be expensed until such time that the hedge matures or is otherwise terminated.

**Noncontrolling Interest**

Of the total equity on our balance sheet at June 30, 2010, \$12 million is noncontrolling interest. Noncontrolling interest represents the aggregate limited partnership (LP) interests in the Fund held by third parties. As of June 30, 2010, the noncontrolling interest represents a 48% third-party interest in the Fund. Income allocated to the noncontrolling interest is based on the third party LP ownership percentage. The ownership percentage is determined

by dividing the number of units held by third party LP investors by the total units outstanding. Subsequent changes, if any, in our ownership percentage would be treated as equity transactions and result in a reallocation between shareholders equity and noncontrolling interest in our consolidated balance sheets.



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June 30, 2010  
(Unaudited)****Note 15. Equity (continued)****Earnings Per Common Share**

The following table provides the basic and diluted earnings (loss) per common share computations for the three and six months ended June 30, 2010 and 2009.

**Basic and Diluted Earnings (Loss) Per Common Share**

| (In Thousands, Except Share Data)   | Three Months Ended June<br>30, |            | Six Months Ended June 30, |             |
|---|--------------------------------|------------|---------------------------|-------------|
|   | 2010                           | 2009       | 2010                      | 2009        |
| Basic Earnings (Loss) Per Common Share:   |                                |            |                           |             |
| Net income (loss) attributable to Redwood   | \$28,601                       | \$6,723    | \$75,444                  | \$(28,222 ) |
| Less: Dividends and undistributed earnings<br>allocated to participating securities | 795                            | 84         | 2,111                     |             |
| Net income (loss) allocated to common<br>shareholders                               | \$27,806                       | \$6,639    | \$73,333                  | \$(28,222 ) |
| Basic weighted average common shares<br>outstanding                                 | 77,800,642                     | 65,697,887 | 77,739,279                | 59,137,864  |
| Basic Earnings (Loss) Per Common Share  | \$0.36                         | \$0.10     | \$0.94                    | \$(0.48 )   |
| Diluted Earnings (Loss) Per Common Share:   |                                |            |                           |             |
| Net income (loss) attributable to Redwood   | \$28,601                       | \$6,723    | \$75,444                  | \$(28,222 ) |
| Less: Dividends and undistributed earnings<br>allocated to participating securities | 685                            | 188        | 1,710                     |             |
| Net income (loss) allocated to common<br>shareholders                               | \$27,916                       | \$6,535    | \$73,734                  | \$(28,222 ) |
| Basic weighted average common shares<br>outstanding                                 | 77,800,642                     | 65,697,887 | 77,739,279                | 59,137,864  |
| Net effect of dilutive equity awards  | 1,051,617                      | 664,836    | 922,363                   |             |
| Diluted weighted average common shares<br>outstanding                               | 78,852,259                     | 66,362,723 | 78,661,642                | 59,137,864  |
| Diluted Earnings (Loss) Per Common Share  | \$0.35                         | \$0.10     | \$0.94                    | \$(0.48 )   |

For the three and six months ended June 30, 2010, there were 1,051,617 and 922,363 dilutive equity awards under the two-class method, respectively. Participating securities were included in the calculation of diluted earnings per common share using the two-class method for the three and six months ended June 30, 2010 and for the three months

ended June 30, 2009, as this computation was more dilutive than using the treasury stock method. For the six months ended June 30, 2009, there were no dilutive equity awards based on our reported net loss for this period. For the three and six months ended June 30, 2010, the number of outstanding equity awards that were antidilutive totaled 681,705 and 582,582, respectively, under the two-class method. For the three and six months ended June 30, 2009, the number of outstanding equity awards that were antidilutive totaled 571,723 and 1,129,834, respectively. There were no other participating securities during these periods.

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June 30, 2010  
(Unaudited)****Note 15. Equity (continued)****Stock Repurchases**

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the three and six months ended June 30, 2010 and 2009, there were no shares acquired under the plan. As of June 30, 2010, there remained 4,658,071 shares available for repurchase under this plan.

**Note 16. Equity Compensation Plans**

As of June 30, 2010 and December 31, 2009, 1,933,344 and 783,911 shares of common stock, respectively, were available for grant under Redwood's Incentive Plan. The unamortized compensation cost under the Incentive Plan and the Employee Stock Purchase Plan totaled \$13 million at June 30, 2010, as shown in the following table.

| (In Thousands)  | Six Months Ended June 30, 2010 |                  |                      |                              | Total     |
|---|--------------------------------|------------------|----------------------|------------------------------|-----------|
|   | Stock Options                  | Restricted Stock | Deferred Stock Units | Employee Stock Purchase Plan |           |
| Unrecognized compensation cost at beginning of period | \$ 879                         | \$ 16,081        | \$                   | \$                           | \$ 16,960 |
| Equity grants   | 17                             | 3,988            | 178                  |                              | 4,183     |
| Equity compensation cost                              | (174 )                         | (7,865 )         | (97 )                |                              | (8,136 )  |
| Unrecognized Compensation Cost at End of Period       | \$ 722                         | \$ 12,204        | \$ 81                | \$                           | \$ 13,007 |

At June 30, 2010, the weighted average amortization period remaining for all of our equity awards was one year.

**Stock Options**

As of June 30, 2010 and December 31, 2009, there were 488,573 and 500,073, respectively, of fully vested stock options outstanding. The aggregate intrinsic value of the options outstanding and options currently exercisable was less than \$1 million at both June 30, 2010 and December 31, 2009.

For both the three and six months ended June 30, 2010, there were 11,500 stock options exercised with an intrinsic value or gain (fair market value less exercise price) of less than \$1 million.

## **Restricted Stock**

As of June 30, 2010 and December 31, 2009, there were 62,951 and 75,645 shares, respectively, of restricted stock outstanding. Restrictions on these shares lapse through January 2014. There were no restricted stock awards granted during the three and six months ended June 30, 2010.

## **Deferred Stock Units**

As of June 30, 2010 and December 31, 2009, there were 1,986,099 and 1,708,326, respectively, DSUs outstanding, of which 931,201 and 294,430, respectively, had vested. There were 108,484 and 471,310 DSUs granted during the three and six months ended June 30, 2010, respectively. During the three and six months ended June 30, 2010, the number of DSUs distributed to participants in the Executive Deferred Compensation Plan (EDCP) totaled 54,601 and 59,559, respectively. Cash distributions to EDCP participants of some of their previously deferred compensation and vested matching totaled less than \$1 million during both the three and six months ended June 30, 2010.

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June 30, 2010  
(Unaudited)****Note 16. Equity Compensation Plans (continued)**

In March 2010, vesting of 376,564 DSUs previously awarded to Mr. George E. Bull, III, was accelerated to June 1, 2010, in connection with the announcement that he would retire from serving as Chief Executive Officer in the second quarter of 2010. We recorded a \$4 million equity compensation expense during the first quarter of 2010 related to modifications of these DSUs.

**Employee Stock Purchase Plan**

The ESPP allows a maximum of 200,000 shares of common stock to be purchased in aggregate for all employees. As of June 30, 2010 and December 31, 2009, 107,011 and 92,479 shares have been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

**Note 17. Operating Expenses**

Components of our operating expenses for the three and six months ended June 30, 2010 and 2009 are presented in the following table.

**Operating Expenses**

| (In Thousands)                | Three Months Ended |           | Six Months Ended |           |
|-------------------------------|--------------------|-----------|------------------|-----------|
|                               | June 30,<br>2010   | 2009      | June 30,<br>2010 | 2009      |
| Fixed compensation expense    | \$ 3,661           | \$ 3,572  | \$ 7,770         | \$ 7,600  |
| Variable compensation expense | 1,303              | 1,132     | 3,183            | 1,688     |
| Equity compensation expense   | 2,077              | 2,337     | 8,136            | 4,132     |
| Severance expense             | 229                |           | 310              | 28        |
| Total compensation expense    | 7,270              | 7,041     | 19,399           | 13,448    |
| Systems                       | 1,734              | 1,233     | 3,311            | 2,826     |
| Office costs                  | 1,783              | 1,675     | 3,548            | 3,426     |
| Accounting and legal          | 45                 | 421       | 1,511            | 980       |
| Other operating expenses      | 395                | 399       | 764              | 628       |
| Total Operating Expenses      | \$ 11,227          | \$ 10,769 | \$ 28,533        | \$ 21,308 |

## Note 18. Taxes

For each of the three and six months ended June 30, 2010, we recognized a provision for income taxes of less than \$1 million. For each of the three and six months ended June 30, 2009, we recognized a benefit for income taxes of less than \$1 million. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at June 30, 2010 and 2009.

### Reconciliation of Statutory Tax Rate to Effective Tax Rate

|  | June 30, |          |
|--|----------|----------|
|  | 2010     | 2009     |
| 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 (loss) | (41.1 )% | (39.8 )% |
| Effective Tax Rate   | 0.1 %    | 1.4 %    |

We assessed our tax positions for all open tax years (Federal years 2006 to 2008, State years 2005 to 2008) and concluded as of June 30, 2010 and December 31, 2009, that we have no material unrecognized tax liabilities.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

**Note 19. Subsequent Events**

As of June 30, 2010, we had issued commitments to purchase \$80 million of mortgage loans. These mortgage purchase commitments contain no penalty or liquidated damages clauses based on our inability to take delivery of mortgage loans, and thus are not recorded on our consolidated balance sheet as of June 30, 2010. As of August 4, 2010, we have purchased \$7 million of mortgage loans, which will be accounted for as held-for-investment.

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

### Introduction

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

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

Our website can be found at [www.redwoodtrust.com](http://www.redwoodtrust.com). We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission (SEC). We also make available, free of charge, access to our Corporate Governance Standards, charters for our Audit Committee, Compensation Committee, and Corporate Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code). In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-GAAP and financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. The information on our website is not part of this Quarterly Report on Form 10-Q.

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

### Cautionary Statement

This Quarterly Report on Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as anticipate, estimate, will, should, expect, believe, intend, seek, plan and similar expressions.



forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

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Statements regarding the following subjects, among others, are forward-looking by their nature:

- our belief that our businesses are on the right path for the future, our beliefs regarding future opportunities to acquire jumbo mortgage loans, our belief that in the future there will be a serious funding shortfall in the
- (i) commercial real estate industry (and related investment opportunities) resulting from the difference between the amount of loans scheduled to refinance and the amount of capital available for refinancing, and our beliefs regarding our competitive position and our ability to compete in the future;
  - (ii) our future capital needs, the strength of our balance sheet, our liquidity, and our expectations regarding the future access to, and use of, short-term debt financing;
    - (iii) changes we may make in the amount of capital we allocate under our risk-adjusted capital policy;
  - (iv) our belief that we will complete additional securitizations through our Sequoia securitization platform; our future investment strategy and our ability to find attractive investments and future trends relating to our pace of acquiring or selling assets, including, without limitation, statements relating to our efforts to acquire residential mortgage loans and about the likelihood and timing of, and our participation in, future securitization transactions and our potential future investment activity in the commercial real estate sector;
  - (v) the future returns we may earn on our investment portfolio, including future trends in interest income; future market and economic conditions, including, without limitation, future conditions in the residential and
  - (vi) commercial real estate markets and related financing markets, and the related potential opportunities for our residential and commercial businesses;
    - (vii) the future competitiveness of our Sequoia securitization platform, including our belief that private sector investors will favor platforms such as the Sequoia platform due to various factors, and our beliefs regarding the willingness of private sector investors to invest in future private sector securitizations of residential mortgage loans;
    - (viii) our statement that some of the senior securities previously issued through our Sequoia securitization platform may incur losses in the future, depending on the magnitude and timing of additional credit losses incurred on the underlying loans;
  - (ix) our beliefs about the future direction of housing market fundamentals, including, without limitation, home prices, mortgage delinquencies, loan modification programs, foreclosure rates, prepayment rates, inventory of homes for sale, and mortgage interest rates and their potential impact on our business and results of operations;
  - (x) our views on the future of governmental programs designed to assist homeowners in avoiding foreclosure by obtaining mortgage loan modifications, and the potential impact on securities we hold in our portfolio;
    - (xi) the potential impacts to our business and the business of our counterparties and competitors of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, including the potential business, legal, and accounting impacts of regulations required to be promulgated under that Act;
    - (xii) the future of the status of Fannie Mae and Freddie Mac, the potential impact to our business as reform of these government-sponsored enterprises remains unclear while it is debated by Congress and the Obama administration, and our belief that the role of these two institutions (and, more generally, that the role of the federal government) in supporting the mortgage finance markets will ultimately decline and open up loan acquisition and securitization opportunities for Redwood;

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- (xiii) our expectations regarding future credit losses and impairments on our investments (including as compared to our original expectations and credit reserve levels), our statement that the amount of credit reserves we designate may require changes in the future, and our belief that our current GAAP income statements are reflective of our current underlying business trends;
- (xiv) the factors that may affect our future earnings, future earnings volatility, and future trends in operating expenses; our belief that we expect to be able to invest significantly in our residential and commercial businesses over time, the size of the pipeline of residential mortgage loans we are committing to buy, the pace at which we may be able to acquire residential mortgage loans in the future, and that we contemplate executing a securitization after acquiring approximately \$300 million of residential mortgage loans depending on market conditions;
- (xv) that in the foreseeable future we do not anticipate raising additional capital or anticipate that Redwood will pay a special dividend; and
- (xvi) our expectations relating to tax accounting, including our anticipation of additional losses for tax accounting purposes, that quarterly taxable income (loss) is difficult to predict and may vary from quarter to quarter, that we currently anticipate reporting a taxable loss in 2010, and that we anticipate that all 2010 dividends will be characterized as a return of capital.

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

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

## **Our Business**

Redwood is a financial institution focused on investing in, financing, and managing residential and commercial real estate loans and securities. Our primary source of income is typically net interest income, which consists of the interest income we earn from our investments less the interest expenses we incur on our borrowed funds and other

liabilities. We assume a range of risks in our investments and the level of risk is

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influenced by the manner in which we finance our purchases of, and derive income from, our investments. Our primary real estate investments include investments in real estate loans and securities, an investment in a private fund that we sponsor – Redwood Opportunity Fund, LP (the Fund), and investments in securitization entities that we sponsor – Sequoia and Acacia.

Our direct investments in residential, commercial, and collateralized debt obligations (CDO) securities are currently financed with equity and long-term debt, although we may use short-term debt financing from time to time, and we may pledge our securities to borrow short-term to fund loans to the extent our securities are more liquid collateral.

These investments are primarily senior and subordinate mortgage-backed securities backed by residential and commercial real estate loans. The long term focus of our operations is to invest in subordinate securities (often below investment grade) that have concentrated structural credit risk. More recently, we have been investing in senior securities (often investment-grade), which have the first right to cash flows in a securitization and therefore have less concentrated credit risk than subordinate securities.

The entities that we sponsor – the Fund, Sequoia, and Acacia – invest in real estate assets. Assets held at the Fund include senior securities backed by non-prime residential and CDO collateral, which were funded through the sale of limited partnership interests to us and to third party investors. The offer and sale of these interests were privately placed and were not registered under the federal securities laws in reliance on an exemption from registration. Assets held at the Sequoia entities include residential real estate loans, which are funded through the issuance of ABS to us and to third party investors. Assets held at the Acacia entities include real estate securities, and some loans and other mortgage related investments, which are funded through the issuance of ABS and equity to us and to third party investors.

Our investments in each of these entities are currently financed with equity and long-term debt. Our capital at risk is limited to our investments in these entities as each entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not obligations of Redwood. For financial reporting purposes, we are generally required to consolidate these entities' assets, liabilities, and noncontrolling interests.

## **Recent Developments**

As we reflect on the second quarter's results, a scan of our financial and operating metrics appears to tell a relatively subdued story for the second quarter of 2010. Our focus and energy has moved from the easy to see, measurable activity of buying secondary senior residential securities to the methodical, behind-the-scenes job of building our residential and commercial business franchises. We are making solid progress despite difficult market conditions, a lack of clarity regarding the legal and regulatory framework that financial institutions and financial markets will be operating under once various financial reform initiatives are finalized, and significant uncertainty as to how long it will take for certain headwinds to subside.

The strength and stability of the economic recovery continues to remain uncertain. Recent economic data hint at a slowdown and mortgage purchase applications are at their lowest level since 1996, even with mortgage rates at forty-year lows. At this point, low mortgage rates are stimulating refinancing activity, not housing demand. In our opinion, the decline in the housing market was one of the primary reasons for the economic recession and housing weakness is a major contributing factor behind the uncertainty surrounding the economic recovery. Continued high unemployment exacerbates that uncertainty along with unresolved questions relating to the implementation of the recent financial reform legislation (the Dodd-Frank Wall Street Reform and Consumer Protection Act), which was largely just a framework with the details left to be hammered-out by various regulatory agencies over the next year. In addition, the government's reform of Fannie Mae and Freddie Mac (the GSEs) is in our view (and the view of many

others) long overdue, introducing yet another element of uncertainty with respect to the future of the mortgage finance markets.

As we navigate the short-term conditions in, and speculation surrounding the future of, the housing market and the economy, we continue to reassess the risks to our balance sheet and the direction of our residential and commercial businesses, as discussed further below under Business Update.

## **Second Quarter Results**

Our second quarter results were in line with our expectations. We reported \$29 million in GAAP income, or \$0.35 per share. In the first quarter of 2010, we reported \$47 million in GAAP income, or \$0.58 per share.

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Each of the first two quarters of 2010 included the benefit of significant gains: \$44 million in the first quarter and \$16 million in the second quarter. Of note, income excluding gains in the second quarter improved markedly from the first quarter's level as a result of lower loan loss provisions, reduced negative market valuation adjustments, and lower operating expenses. These improvements were only partially offset by lower net interest income. In the second quarter, loan loss provisions of \$4 million were at about half the level of the first quarter's \$9 million level. In the second quarter, we posted negative market valuation adjustments of \$7 million versus \$11 million negative adjustments in the first quarter.

We estimate that taxable income was slightly negative in the second quarter of 2010. We expect negative taxable income to persist as credit losses come through. Credit issues impact taxable income when write-offs are taken, since we are not allowed to establish reserves for tax purposes. Governmental efforts to slow and reduce foreclosures have temporarily delayed many loan write-offs. If there is a reduction in the government's efforts to forestall foreclosures and there are clear signals that this is happening we expect credit losses to increase as liquidations occur. We do not currently anticipate having a REIT requirement to pay dividends based on taxable income for 2010.

Book value per share on a GAAP basis ended the second quarter at \$12.71, representing a \$0.13 decline from \$12.84 at the end of the first quarter. Book value declined in the quarter even as earnings exceeded dividends principally due to the decline in the value of the interest rate hedges against our long term borrowings. Our non-GAAP estimate of economic value per share ended the second quarter at \$13.37 as compared with \$13.32 at the end of the first quarter. (See Table 2 below under Summary of Results of Operations, Financial Condition, Capital Resources and Liquidity for a reconciliation of GAAP book value per share to our non-GAAP estimate of economic value per share.) Neither our GAAP book value per share nor non-GAAP estimate of economic value per share was significantly impacted this quarter by changes in prices of the types of securities we hold, as prices generally closed the quarter about where they started. We continue to have ample liquidity and ended the second quarter with \$288 million in cash, up from \$242 million at March 31, 2010.

On the asset side of our balance sheet, we ended the second quarter with 25% of our capital (long-term debt and equity) in cash and 64% of our capital in seasoned senior residential mortgage-backed securities (RMBS). We have culled this RMBS portfolio over the past several quarters with the intent of retaining the most well-protected risk-adjusted cash flows. If there are negative developments, such as an extended downturn in the housing market, and RMBS prices fall to more attractive levels, we will look to use our excess cash to capitalize on investment opportunities. Conversely, if the economic and employment picture significantly improves, there would presumably be less need for government support in the mortgage market, which should open up private market securitization opportunities for us. On the liability side of our balance sheet at June 30, 2010, we ended the second quarter with little exposure to liquidity risk. We are principally funded with equity and long-term subordinate notes due in 2037.

## **Business Update**

### **Residential Portfolio Business**

Over the past 18 months, the primary investment focus of our portfolio team has been the acquisition of seasoned, senior non-agency RMBS. We said at the outset that this was a very attractive, but limited investment opportunity that would eventually run its course. The combination of strong demand for RMBS by fixed income investors and banks, a dwindling supply of RMBS, and historically low Treasury rates has driven unlevered yields for RMBS assets to levels generally unattractive to us. These market forces seem pretty well embedded. Unless the market dynamics change, we expect to make selective RMBS investments that meet our criteria in the context of limited market supply. We have, however, taken advantage of these market conditions to sell certain of our portfolio investments when we believed the

market was willing to pay a price for them that we believed was not reflective of the risk of continuing to hold them.

During the second quarter, we acquired \$23 million and sold \$116 million of non-agency mortgage-backed securities, reducing the size of our securities portfolio from \$840 million at March 31, 2010 to \$734 million at June 30, 2010. Credit losses on this portfolio have been in line with our expectations and prepayment rates on this portfolio have been at or above our expectations. In July 2010, we purchased

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\$24 million of non-agency mortgage-backed securities. Our portfolio group will, as always, be looking for other attractive residential investment and structuring opportunities.

## **Residential Mortgage Loan Business**

Upon review of our residential mortgage loan business, taking into account that the federal government is backing roughly 95% of all mortgages originated in the first quarter of 2010, we feel quite certain the government's role in mortgage finance will ultimately decline, allowing the private sector to return to a more historically normal level of activity. For most of the past twenty years until just a few years ago the private sector backed between 40% and nearly 70% of residential mortgages. In April 2010, we completed the first private residential mortgage securitization in the market in the last two years. This new residential securitization reinforced our belief that institutional investors are ready to be active investors in non-government mortgage-backed securities with high-quality collateral if the right protections are in place. In this regard, our goals for completing this securitization were to have positive economics, address issues and concerns of relevant stakeholders, and take a leading role in setting standards for future securitizations. We also had a goal to inform government policy. We achieved our goals. Regarding policy, we have been meeting with policymakers about private market securitizations. We have also presented our proposed plan for the reform of the GSEs with the U.S. Department of Treasury.

Our primary business is to invest in first-loss positions in securitized pools of residential mortgage loans. Our balance sheet is well positioned to hold these long-term, illiquid investments. Effectively, we credit enhance mortgage loans with capital, facilitating the process of channeling funds from savers to borrowers through the private market, via securitization. We can do this in two ways. First, we can team with banks and other originators to provide capital for their transactions. Alternatively, we can acquire quality loans through our loan conduit, securitize these loans through our Sequoia program, and create our own investments. This is our preferred strategy.

We have made improvements to our securitization process which we believe enhance our competitive advantages. We have re-oriented the process to start with the investors who purchase the triple-A securities issued in a securitization transaction. These triple-A investors provide over 90% of the financing for a securitization. In our securitization process we consider the preferences of triple-A investors when establishing the structure and loan collateral criteria for the securitization. With respect to lenders who originate loans, we are delivering loan price and purchase commitments on a flow basis. From a securitization model standpoint, we believe that triple-A investors will favor sponsors who are independent of the originator/servicer and less conflicted. Additionally, we believe triple-A investors will favor sponsors who are willing to hold those tranches that are most exposed to credit risk. To that point, we expect to retain risk horizontally in our securitizations, regardless of how securitization reform regulations are drafted.

We are committing to purchase mortgage loans from a few companies who originate prime quality loans that meet our collateral criteria. We are in continuing discussions to add additional significant originators to our platform. As of July 31, 2010, we had issued commitments to purchase \$154 million of mortgage loans and we are ramping up activity gradually as expected. We have committed to purchase a mix of 10-year hybrid rate and 30-year fixed rate loans, the types of loans banks are least able to match fund. We are encouraged by our progress and contemplate completing a securitization once we reach approximately \$300 million of purchased loans, possibly in 2010, depending on market conditions.

Mortgage loan purchase volume is currently constrained by headwinds. The government's outsized role in the mortgage market is a primary headwind, as we discussed earlier. The GSE's elevated conforming limits have caused a significant increase in loan volume to go through Fannie Mae and Freddie Mac. For context, in 2009, there were \$192

billion of residential mortgage originations over the \$417,000 standard conforming limit, \$100 billion (52%) of which went primarily to Fannie Mae and Freddie Mac instead of the private sector. The remaining 48% were retained on the balance sheets of banks. Lower levels of housing finance activity and lower home prices mean fewer originations over the GSE conforming limits limiting opportunities to purchase loans. Banks desire to retain high quality assets also limits loans available to purchase.

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We believe opportunities to acquire mortgage loans will improve with reform of the GSEs. In particular, if reform of the GSEs reduces their future market share or limits the scope of their activities (for example, by reducing conforming loan size limits), then less mortgage loans would be sold to Fannie Mae and Freddie Mac (and, presumably, more loans would be available for purchase by institutions like Redwood). In addition, loan purchase opportunities should improve if banks retain fewer of the jumbo mortgage loans they originate. For economic reasons bank may retain fewer loans if we see the return of a more normal yield curve, in which case more loans should be available for purchase by institutions like Redwood. It is also possible that GAAP accounting rules could be interpreted to require banks to consolidate securitization entities that they retain risk in, which could potentially incentivize them (for accounting and regulatory capital reasons) not to sponsor securitizations of loans they originate and, instead, to sell loans to others institutions, such as Redwood.

### **Commercial Mortgage Business**

As a review of our commercial business, we continue to build our origination and investment team in anticipation of a serious shortfall of funding availability to meet the significant funding needs in the commercial mortgage sector over the next five years. We continue to believe the long-term investment opportunity in commercial real estate loans is vast. To illustrate, there were \$250 billion in commercial loans with scheduled maturities in 2009 yet only \$111 billion of new originations and refinancings were reported for the year. Some estimate a need for \$1.4 trillion in commercial refinancing over the next five years. We believe the available sources of commercial mortgage financing falls far short of this amount.

The extend and pretend environment within the commercial real estate sector where borrowers and lenders alike defer the recognition of property value declines on commercial properties will end, though we don't know when. Over the past nine months, REITs and fund managers have raised a significant amount of capital with the expectation of capitalizing on a large and attractive supply of refinancing and distressed opportunities. The majority of this capital sits frustratingly idle as the actual commercial refinance activity has been muted as lenders and borrowers defer the recognition of property valuation declines. Furthermore, for the few attractive deals in the market competition has been fierce.

We remain focused on quality borrowers and properties. Most recently, we are somewhat encouraged by the pick-up we are seeing in potential mezzanine investment opportunities where we would team with senior mortgage lenders. We are simultaneously exploring potential investment opportunities in multi-family properties. To the extent we begin investing in commercial assets, we intend to manage our risks carefully and focus on execution. Commercial mortgage investments are a good fit with our long-term oriented business model and balance sheet.

### **Outlook**

We believe that we have a strong, well-protected balance sheet and that our residential and commercial businesses are strategically well positioned. We also believe that the investment opportunities in these businesses will ultimately far exceed our existing capital. The biggest issue in our minds is time.

As of July 31, 2010, we had \$258 million in cash and given our operating environment we cannot be certain by what date our excess capital will be invested. While there is a cost to holding capital in the form of cash, there are also a number of important benefits. Holding cash is a relatively low cost option we expect to be able to invest significantly in our residential and commercial businesses over time. Next, cash makes us relevant to counterparties and holding cash gives us flexibility to take advantage of opportunities that will become available if the environment were to unexpectedly worsen.

In the foreseeable future, we do not anticipate raising additional capital and we do not anticipate that Redwood will pay a special dividend. While holding roughly 30% of our capital in cash will not generate significant earnings, we are keenly aware of the risk of too hastily investing capital to boost near term earnings. We are confident that our businesses are on the right path to achieve our goal of producing high quality, long-term cash flows. We are working on multiple fronts to expand our near-term investment opportunities.

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## Summary of Results of Operations, Financial Condition, Capital Resources, and Liquidity

Our reported GAAP net income was \$29 million (\$0.35 per share) for the second quarter of 2010, as compared to \$7 million (\$0.10 per share) for the second quarter of 2009. Our GAAP book value per common share was \$12.71 at June 30, 2010, an increase from \$10.35 at June 30, 2009. We declared regular quarterly dividends of \$0.25 per share for both the first and second quarters of 2010 and 2009.

The following table presents the components of our GAAP net income (loss) for the three and six months ended June 30, 2010 and 2009.

**Table 1 Net Income**

| (In Thousands, Except Share Data)   | Three Months Ended June 30, |            | Six Months Ended June 30, |             |
|---|-----------------------------|------------|---------------------------|-------------|
|   | 2010                        | 2009       | 2010                      | 2009        |
| Interest income   | \$56,570                    | \$74,261   | \$115,288                 | \$155,698   |
| Interest expense  | (21,164 )                   | (39,001 )  | (39,346 )                 | (86,642 )   |
| Net interest income   | 35,406                      | 35,260     | 75,942                    | 69,056      |
| Provision for loan losses   | (4,321 )                    | (14,545 )  | (13,797 )                 | (30,577 )   |
| Market valuation adjustments, net   | (7,125 )                    | (29,135 )  | (18,362 )                 | (72,379 )   |
| Net interest income (loss) after provision and market valuation adjustments | 23,960                      | (8,420 )   | 43,783                    | (33,900 )   |
| Operating expenses  | (11,227 )                   | (10,769 )  | (28,533 )                 | (21,308 )   |
| Realized gains, net   | 16,080                      | 25,525     | 60,417                    | 25,988      |
| Provision for income taxes  | (26 )                       | 514        | (52 )                     | 409         |
| Less: Net income (loss) attributable to noncontrolling interest             | 186                         | 127        | 171                       | (589 )      |
| Net Income (Loss)   | \$28,601                    | \$6,723    | \$75,444                  | \$(28,222 ) |
| Diluted weighted average common shares outstanding                          | 78,852,259                  | 66,362,723 | 78,661,642                | 59,137,864  |
| Net earnings (loss) per share   | \$0.35                      | \$0.10     | \$0.94                    | \$(0.48 )   |

Net interest income was \$35 million for both the second quarter of 2010 and 2009. Net interest income after provision and market valuation adjustments (MVA) was \$24 million for the second quarter of 2010 as compared to negative \$8 million in the second quarter of 2009, an increase of \$32 million. This increase was primarily due to lower negative market valuation adjustments at Redwood due to fewer impairment charges on securities and a \$10 million decrease in the provision for loan losses at Sequoia due to lower balances of residential loans and a decrease in the rate at which delinquencies rose.

Operating expenses were \$11 million for both the second quarter of 2010 and 2009. Decreases in accounting and legal expenses were offset by increases in system costs and compensation expenses. We currently expect our quarterly operating expenses in 2010 to remain generally consistent with the expenses incurred in the second quarter of 2010.

Realized gains, net, were \$16 million for the second quarter of 2010 as compared to \$26 million for the second quarter of 2009, a decrease of \$10 million. This decrease was due to a \$19 million gain on the deconsolidation of certain Sequoia securitization entities in the second quarter of 2009, partially offset by higher gains on the sale of securities in

the second quarter of 2010.

The Results of Operations section of this Management's Discussion and Analysis of Financial Condition and Results of Operations contains a detailed analysis of the components of net income.

Our estimated total taxable loss was \$3 million (\$0.03 per share) for the second quarter of 2010 as compared to a taxable loss of \$12 million (\$0.16 per share) for the second quarter of 2009, an improvement of \$9 million. Our estimated REIT taxable income was \$3 million (\$0.04 per share) for the second quarter of 2010 as compared to a REIT taxable loss of \$10 million (\$0.13 per share) for the second quarter of 2009, an increase of \$13 million. The increase in taxable income was primarily due to a decrease in realized credit

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losses on subordinate securities. Total realized credit losses for the second quarters of 2010 and 2009 were \$24 million and \$50 million, or \$0.31 and \$0.65 per share, respectively.

Our REIT taxable income is that portion of our total taxable income that we earn at Redwood and its qualifying REIT subsidiaries and determines the minimum amount of dividends we must distribute to shareholders in order to maintain our tax status as a REIT. As a result of our expectation that we will incur a REIT taxable loss in 2010, we currently expect that this year's distributions will be characterized as return of capital. However, if credit losses remain at lower levels than experienced in recent quarters and we do generate positive taxable income, a portion of the distributions would be characterized as ordinary income (to the extent of the 2010 income).

### Components of Book Value

The Financial Condition and Capital Resources and Liquidity sections of this Management's Discussion and Analysis of Financial Condition and Results of Operations contains a detailed discussion and analysis of the components of GAAP book value at June 30, 2010 and December 31, 2009. The following supplemental non-GAAP components of book value addresses our assets and liabilities at June 30, 2010, as estimated under GAAP and as estimated by us using fair values for our investments and long-term debt. We show our investments in the Fund and the Sequoia and Acacia entities as separate line items to highlight our specific ownership interests, as the underlying assets and liabilities of these entities are legally not ours. Our non-GAAP estimated economic value is calculated using bid-side asset marks (or estimated bid-side values) and offer-side marks for our financial liabilities (or estimated offered-side values), as required to determine fair value under GAAP. We believe this method of calculating economic value more closely represents liquidation value and does not represent the higher amount we would have to pay at the offered-side to replace our existing assets or the higher amount we would have to pay to redeem our liabilities. For additional information to consider when reviewing the following table, please see Factors Affecting Management's Estimate of Economic Value and Investments in the Fund and Securitization Entities below.

**Table 2 Book Value and Economic Value at June 30, 2010**

| (In Millions, Except per Share Data)    | GAAP<br>Book Value | Adjustments | Estimate of<br>Non-GAAP<br>Economic<br>Value |
|---|--------------------|-------------|--|
| Cash and cash equivalents               | \$ 288             | \$          | \$ 288                                       |
| Real estate securities at Redwood       |                    |             |  |
| Residential                             | 725                |             | 725  |
| Commercial                              | 8                  |             | 8  |
| CDO                                     | 1                  |             | 1  |
| Total real estate securities at Redwood | 734                |             | 734  |
| Investments in the Fund                 | 15                 |             | 15   |
| Investments in Sequoia                  | 101                | (25 )       | 76   |
| Investments in Acacia                   | 3                  | (2 )        | 1  |
| Total cash, securities, and investments | 1,141              |             | 1,114  |
| Long-term debt                          | (140 )             | 78          | (62 )  |
| Other assets/liabilities, net           | (10 )              |             | (10 )  |
| Stockholders' Equity                    | <b>\$ 991</b>      |             | <b>\$ 1,042</b>                              |
| Book Value Per Share                    | <b>\$ 12.71</b>    |             | <b>\$ 13.37</b>                              |

During the second quarter of 2010, our GAAP book value decreased by \$0.13 per share to \$12.71 per share at June 30, 2010, as compared to March 31, 2010. The decrease was the result of \$0.41 per share of earnings before market valuation adjustments and \$0.02 per share from equity issuance related to dividend reinvestment less \$0.26 per share of unrealized loss on cash flow hedges, \$0.05 per share of negative market valuation adjustment, and \$0.25 per share of dividends paid to shareholders. During the second quarter our estimate of non-GAAP economic value increased by \$0.05 per share to \$13.37 per share. The increase was the result of \$0.23 per share from net cash flows and net positive market valuation adjustments on our securities and investments, \$0.14 from valuation changes related to our long-term debt, and \$0.02 per share from equity



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issuance related to dividend reinvestment less \$0.09 per share of cash operating and interest expense and \$0.25 per share of dividends paid to shareholders. Economic value is determined by calculating the fair value of our investments in consolidated entities directly as opposed to deriving their reported GAAP values by netting their consolidated assets and liabilities. In calculating our estimate of economic value, we also value our long-term debt at its estimated fair value rather than its amortized cost basis as reported for GAAP.

**Factors Affecting Management's Estimate of Economic Value**

In reviewing our non-GAAP estimate of economic value, there are a number of important factors and limitations to consider. The estimated economic value of our stockholders' equity is calculated as of a particular point in time based on our existing assets and liabilities or, in certain cases, our estimate of economic value of our existing assets and liabilities, and does not incorporate other factors that may have a significant impact on that value, most notably the impact of future business activities and cash flows. As a result, the estimated economic value of our stockholders' equity does not necessarily represent an estimate of our net realizable value, liquidation value, or our market value as a whole. Amounts we ultimately realize from the disposition of assets or settlement of liabilities may vary significantly from the estimated economic values of those assets and liabilities. Because temporary changes in market conditions can substantially affect our estimate of the economic value of our stockholders' equity, we do not believe that short-term fluctuations in the economic value of our assets and liabilities are necessarily representative of the effectiveness of our investment strategy or the long-term underlying value of our business. When quoted market prices or observable market data are not available to estimate fair value, we rely on Level 3 inputs. Because assets and liabilities classified as Level 3 are generally based on unobservable inputs, the process of calculating economic value is generally subjective and involves a high degree of management judgment and assumptions. These assumptions may have a significant effect on our estimates of economic value, and the use of different assumptions as well as changes in market conditions could have a material effect on our results of operations or financial condition.

**Cash, Securities, and Investments at Redwood**

We have segmented our securities portfolio by acquisition date in the chart below to highlight that 91% of the economic value of our cash, securities, and investments are held in cash or in recently acquired securities as of June 30, 2010. Our future earnings will be primarily driven by the performance of these recent investments along with how we deploy our existing cash and future cash flows.

**Cash, Securities, and Investments at Redwood  
June 30, 2010  
(\$ in millions)**

\* Estimate of non-GAAP economic value; see Table 2 for explanation and reconciliation to GAAP.

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The following table presents the components of fair value (which equals GAAP carrying value) for real estate securities at Redwood at June 30, 2010. We categorize our securities by portfolio vintage (the year(s) the securities were issued), by priority of cash flows – senior, re-REMIC, and subordinate – and, for residential, by quality of underlying loans – prime and non-prime.

**Table 3 Securities at Redwood by Vintage and as a Percentage of Total Securities**

| June 30, 2010<br>(In Millions) | 2004 &<br>Earlier | 2005   | 2006   | 2008 | Total  | % of Total<br>Securities |
|--------------------------------|-------------------|--------|--------|------|--------|--------------------------|
| Residential                    |                   |        |        |      |        |                          |
| Senior                         |                   |        |        |      |        |                          |
| Prime                          | \$ 14             | \$ 227 | \$ 69  |      | \$ 310 | 42 %                     |
| Non-prime                      | 114               | 197    | 9      |      | 320    | 44 %                     |
| Total Senior                   | 128               | 424    | 78     |      | 630    | 86 %                     |
| Re-REMIC prime                 | 5                 | 9      | 55     |      | 69     | 9 %                      |
| Subordinate                    |                   |        |        |      |        |                          |
| Prime                          | 12                | 3      | 1      |      | 16     | 2 %                      |
| Non-prime                      | 9                 | 1      |        |      | 10     | 2 %                      |
| Total Subordinate              | 21                | 4      | 1      |      | 26     | 4 %                      |
| Total Residential              | 154               | 437    | 134    |      | 725    | 99 %                     |
| Commercial                     | 7                 | 1      |        |      | 8      | 1 %                      |
| CDO                            |                   | 1      |        |      | 1      | %                        |
| Total Securities at Redwood    | \$ 161            | \$ 439 | \$ 134 |      | \$ 734 | 100 %                    |

During the second quarter of 2010, our securities portfolio declined from \$840 million to \$734 million, primarily as a result of sales of \$100 million and paydowns exceeding acquisitions. In addition, the value of the securities still held at June 30, 2010, decreased by \$2 million during the period.

The following chart shows market prices for senior RMBS securities since June 2008.

## Senior RMBS Prices

*Source: JPMorgan Chase*

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**Investments in the Fund and Securitization Entities**

The GAAP reported value of our investments in the Fund, Sequoia entities, and Acacia entities totaled \$119 million, or 12% of our equity at June 30, 2010. The fair value (which equals GAAP carrying value) of our investment in the Fund was \$15 million. The Fund is primarily invested in non-prime residential securities and is managed by a subsidiary of Redwood. Our investment represents a 52% interest in the Fund.

The GAAP carrying value of our investments in Sequoia entities was \$101 million and the fair value was \$76 million. The \$76 million of fair value consists of \$43 million of interest-only securities (IOs) and \$33 million of senior and subordinate securities and is calculated using the same valuation process that we follow to fair value our other real estate securities. These IOs earn the spread between the coupon rate on the \$2.4 billion notional amount of underlying adjustable rate mortgage (ARM) loans and the cost of funds (indexed to one-month LIBOR) on the ABS issued within each respective securitization entity. Returns on IOs increase when prepayments slow and decrease when prepayments speed up.

The GAAP carrying value and fair value of our investments in Acacia entities was \$3 million and \$1 million at June 30, 2010, respectively. These investments consist of equity interests and securities in the Acacia entities we sponsor, which have minimal value, as well as the value of future management fees we expect to receive from Acacia entities, which we discounted at a 45% rate.

**Capital Resources and Liquidity**

Throughout the second quarter of 2010, we maintained our strong balance sheet and liquidity. We ended the second quarter of 2010 with total capital of \$1.1 billion, which consists of \$991 million of common equity and \$140 million of 30-year long-term debt due in 2037. We had no short-term debt at June 30, 2010, though we did carry some short-term debt at times during the second quarter. We use our capital to invest in earning assets, fund our operations, fund working capital, and meet lender capital requirements with respect to collateralized borrowings, if any. Through our internal risk-adjusted capital policy, we allocate capital for our earning assets to meet liquidity needs that we estimate may arise. We generally allocate capital equal to 100% of the fair value of all our investments, a policy that has served us well over the past few years of market turmoil. We have successfully managed through two tumultuous periods (1998 and 2008) and we will remain thoughtful about managing funding risk when we re-enter the short-term debt market.

As we have started to acquire residential mortgage loans in July for future securitization and have the ability to access financing during the accumulation period, we have allocated less than 100% capital on these residential loans under our risk-adjusted capital policy. In addition, we may change the amount of capital we allocate to the more liquid securities we own. Consistent with our past practices, we will make these changes only when we believe it is in the best long-term interest of our shareholders. We believe we have significantly greater capital capacity than reflected in our stated excess capital amounts, given our conservative choice to allocate 100% capital to most of our assets. Excess capital generally equals our cash balance less pending investment settlements and other internal capital allocations we have established for the prudent operations of our company. Our excess capital at June 30, 2010 was \$240 million and at July 31, 2010 was \$178 million. Given the amount of our excess capital, it seems unlikely we would seek additional capital in the near term. If circumstances should change, we would likely look first at our own balance sheet for sources of cash before considering other options.

At June 30, 2010, we had \$288 million in cash and cash equivalents, or \$3.70 per share, and at July 31, 2010, we had \$258 million in cash and cash equivalents, or \$3.31 per share. Most of our cash and cash equivalents were invested in

U.S. Treasury Bills. Our quarterly sources and uses of our cash is one of the financial metrics on which we focus. Therefore, as a supplement to the Consolidated Statements of Cash Flows included in this Quarterly Report on Form 10-Q, we show in the table below (i) the beginning cash balances at March 31, 2010 and December 31, 2009 (which are GAAP amounts), (ii) the ending cash balances at June 30, 2010 and March 31, 2010 (which are GAAP amounts), and (iii) the components of sources and uses of cash organized in a manner consistent with the way management analyzes them by aggregating and netting all items within our GAAP Consolidated Statements of Cash Flows that were attributable to the quarters presented. This table excludes the gross cash flow generated by our Sequoia and Acacia securitization entities and the Fund (cash flow that is not available to Redwood), but does include the cash flow distributed to Redwood as a result of our investments in these entities. In addition, please note that in the table below we

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now include proceeds from sales as a component of business cash flow and as part of cash flow from securities and investments. While it is our intention when we acquire assets to hold them to maturity and receive principal and interest payments over their lives, we sell assets from time to time as part of our continuing management of expected risk and return. A sale effectively accelerates the receipt of cash flow we would have otherwise expected to receive over time.

In the second quarter of 2010, our business cash flow remained strong and in line with our expectations. Our business cash flow exceeded our cash operating expenses, acquisitions, and dividend distributions. We ended the quarter with \$288 million of cash, up from \$242 million at the end of the prior quarter.

**Table 4 Redwood Sources and Uses of Cash**

| (In Millions)                             | Three Months Ended |                   |
|---|--------------------|-------------------|
|   | June 30,<br>2010   | March 31,<br>2010 |
| Beginning Cash Balance                    | \$ 242             | \$ 243            |
| Business cash flow                        |                    |                   |
| Cash flow from securities and investments | 177                | 193               |
| Cash operating expenses                   | (10 )              | (15 )             |
| Interest expense on long-term debt        | (1 )               | (1 )              |
| Total business cash flow                  | 166                | 177               |
| Other sources and uses                    |                    |                   |
| Investment in 2010 Sequoia                | (28 )              |                   |
| Changes in working capital                | 3                  | (2 )              |
| Acquisitions <sup>(1)</sup>               | (55 )              | (156 )            |
| Derivative margins posted, net            | (20 )              |                   |
| Dividends                                 | (20 )              | (20 )             |
| Net other uses                            | (120 )             | (178 )            |
| Net sources (uses) of cash                | 46                 | (1 )              |
| Ending Cash Balance                       | \$ 288             | \$ 242            |

Total acquisitions in the second quarter of 2010 were \$23 million, \$1 million of which are not reflected in this table (1) because they did not settle until early July. Also, \$33 million of acquisitions made in the first quarter that did not settle until early April are reflected in this table.

We believe our current GAAP income statements are reflective of our current underlying business trends, especially given the nature of the assets we currently hold. We consider cash flow one of a number of other important operating metrics; however, we realize that quarterly cash flow measures have limitations. In particular, we note:

When securities are purchased at large discounts from face value it is difficult to determine what portion of the cash received is a return of principal and what portion is a return on principal. It is only at the end of an asset's life that we can accurately determine what portion of the cumulative cash received (whether principal or interest) was income and what was a return of capital.

Certain investments may generate cash flow in a quarter that is not necessarily reflective of the long-term economic yield we will earn on the investments. For example, we acquired certain re-REMIC support securities at what we believe to be attractive yields. Due to their terms, however, these securities are locked out of receiving any principal payments for years. Because of the deferred receipt of principal payments, formulating any conclusions on the value

or performance of these securities by looking solely at the early quarterly cash flow may not be indicative of economic returns.

Cash flow from securities and investments can be volatile from quarter to quarter depending on the level of invested capital, the timing of credit losses, acquisitions, sales, and changes in prepayments and interest rates.

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The table below presents the source of our cash flow from securities and investments for the three months ended June 30, 2010 and March 31, 2010.

**Table 5 Cash Flow from Securities and Investments**

| (In Millions)  | Three Months Ended |                   |
|--|--------------------|-------------------|
|  | June 30,<br>2010   | March 31,<br>2010 |
| Securities at Redwood                                  |                    |                   |
| Residential senior                                     |                    |                   |
| Principal and interest                                 | \$ 42              | \$ 40             |
| Proceeds from sales                                    | 111                | 73                |
| Total residential senior                               | 153                | 113               |
| Residential Re-REMIC                                   |                    |                   |
| Principal and interest                                 | 2                  | 3                 |
| Proceeds from sales                                    | 5                  | 51                |
| Total residential Re-REMIC                             | 7                  | 54                |
| Residential subordinates principal and interest        | 8                  | 8                 |
| Commercial and CDO subordinates principal and interest | 1                  | 1                 |
| Total cash flow from securities at Redwood             | 169                | 176               |
| Investments in the Fund                                | 1                  | 9                 |
| Investments in Sequoia entities                        | 7                  | 8                 |
| Investments in Acacia entities                         |                    |                   |
| Total Cash Flow from Securities and Investments        | \$ 177             | \$ 193            |

Total cash flow from securities and investments was \$177 million for the second quarter of 2010, a decrease of \$16 million from first quarter, primarily due to a decreased level of security sales at Redwood and the Fund. Total proceeds from the sale of senior and re-REMIC securities at Redwood were \$116 million in the second quarter, compared to \$124 million in first quarter, primarily due to a decreased level of sales of our re-REMIC securities. Redwood's investment in the Fund generated \$1 million of cash flow in the second quarter, compared to \$9 million in the prior quarter, due to a decreased level of sales in the second quarter. In the first quarter, our share of the proceeds from asset sales represented \$7 million of the cash received.

**Litigation and Governmental Investigations and Enforcement Actions**

As described in Note 14 Commitments and Contingencies Loss Contingencies Litigation, which is included within the Notes to Consolidated Financial Statements set forth within Part I, Item 1 of this Quarterly Report on Form 10-Q, in December 2009, a lawsuit was filed against us relating to the purchase by the Federal Home Loan Bank of Seattle ( FHLB-Seattle ) of a residential mortgage-backed security ( RMBS ) issued in 2005 by a securitization trust with respect to which our subsidiary, Sequoia Residential Funding, Inc. was the depositor. In addition, and as also described in the above-referenced Note 14, in July 2010, the Federal Home Loan Bank of Chicago ( FHLB-Chicago ) delivered to us two notices of Election to Void Sale of Securities relating to two RMBS that were issued in 2006 by a securitization trust with respect to which our subsidiary, Sequoia Residential Funding, Inc. was the depositor. The notices demand that these two RMBS be repurchased from the FHLB-Chicago pursuant to the Illinois state securities laws. We believe the claims and demands made by the FHLB-Seattle and the FHLB-Chicago are without merit, although it is possible that we may not be successful in defending any litigation brought against us and any losses incurred as a result of any judgment against us could have a material adverse effect on our results of operations in future periods. In any case,

regardless of the merits of any demand or legal action brought against us, or of our success in defending against it, the costs of defending against demands or litigation brought against us may be significant or material and could have a material adverse effect on our results of operations in future periods.

Various Federal Home Loan Banks that make up the Federal Home Loan Bank System are pursuing litigation against various parties in relation to their respective portfolio holdings of RMBS. As examples, (i) in September and October 2009 the Federal Home Loan Bank of Pittsburgh initiated litigation against various



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RMBS market participants relating to RMBS held within its portfolio (we were not named in this litigation), (ii) in March 2010 the Federal Home Loan Bank of San Francisco initiated litigation against various RMBS market participants relating to RMBS held within its portfolio (we were not named in this litigation), and (iii) in December 2009 the Federal Home Loan Bank of Seattle initiated litigation against various RMBS market participants (including, as noted above, us) relating to RMBS held within its portfolio. There are a total of twelve Federal Home Loan Banks within the Federal Home Loan Bank System and those that have not yet initiated litigation or demands of the type described above may do so in the future and those that have already initiated litigation or demands of the type described above may expand the scope of the litigation or demands that they have initiated to date. Any newly initiated or expanded litigation or demands by the Federal Home Loan Banks may include new or additional demands or litigation against us or our subsidiaries to the extent that Federal Home Loan Banks purchased at issuance or in the secondary market RMBS issued through our Sequoia RMBS platform.

Other investors in RMBS have also initiated various legal actions against RMBS market participants and those that invested in RMBS issued through our Sequoia RMBS platform may initiate legal actions against us, particularly if the Federal Home Loan Banks and other investors who have initiated legal actions against us and others are successful, in whole or in part, in the pursuit of their claims against us or other RMBS market participants. Claims by investors in RMBS have included, among other things, allegations that the offering materials relating to the issuance of a RMBS were materially misleading or omitted to state material information. Please see the Risk Factors included in our Annual Report on Form 10-K for fiscal year ended December 31, 2009, including, without limitation, the Risk Factor entitled Our past and future securitization activities or other past and future business activities could expose us to litigation, which may adversely affect our business and results of operations, which is set forth on page 18 of that Annual Report.

Various governmental authorities have also initiated investigations, enforcement actions, and litigation with respect to, among other things, the mortgage finance markets, RMBS transactions, and collateralized debt obligation (CDO) transactions and the market participants who structured, sponsored, marketed, or sold transactions or securities relating to these markets and securities. For example, Goldman Sachs recently reached a \$550 million settlement relating to civil charges brought by the Securities and Exchange Commission ( SEC ) relating to Goldman Sachs role in structuring and marketing a synthetic CDO transaction referred to as Abacus 2007-AC1. As another example, the SEC recently initiated a lawsuit against an asset management firm named ICP Asset Management (and certain other related entities and individuals) alleging violations of law by ICP Asset Management in the conduct of its business as the collateral manager of various CDO transactions. As another example, the Federal Housing Finance Agency, which is the federal agency that regulates Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, recently issued 64 subpoenas to institutions that participated in RMBS transactions in which Fannie Mae or Freddie Mac invested, as part of a financial inquiry that is seeking information to determine whether losses sustained by Fannie Mae and Freddie Mac from these investments are the legal responsibility of others and to ensure that the obligations of the various parties involved have been met.

Our business has included, and continues to include, activities relating to securitization and CDO transactions, areas that are the focus of various governmental authorities. Because of our involvement in the securitization and CDO businesses, we could become the subject of governmental investigations, enforcement actions, or lawsuits and governmental authorities could allege that we violated applicable law or regulation in the conduct of our business. If violations are so alleged, we might not be successful in defending any related action brought against us and any losses incurred as a result of the resolution of any such action against us could have a material adverse effect on our results of operations in future periods. In any case, regardless of the merits of any allegation or legal action that may be brought against us, or of our success in defending against it, the costs of defending against any such allegation or legal action made or brought against us may be significant or material and could have a material adverse effect on our results of operations in future periods. To the extent that any action is brought against us or other market participants

by any governmental authority, regardless of whether that action is successful or not, it could result in non-governmental litigants bringing similar actions against us to the extent the law permits private parties to pursue legal action to address alleged violations of law or regulation. As described below, we have been required to provide information to federal agencies in two investigations.

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In May 2010, we received an Order from the SEC, pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. The SEC's Order required us to provide information regarding, among other things, our trading practices and valuation policies relating to our Acacia CDO business. We have responded to the Order. The Order from the SEC indicates that it should not be construed as an indication by the SEC or its staff that any violations of law have occurred. The SEC could, however, as a result of this investigation or otherwise, allege that we violated applicable law or regulation in the conduct of our CDO business and, if it was to make such an allegation, it is possible that we might not be successful in defending any related action brought against us and any losses incurred as a result of the resolution of any such action against us could have a material adverse effect on our results of operations in any future period.

In November 2009, we received a subpoena from the National Credit Union Administration (NCUA), which is the federal agency that charters and supervises federal credit unions, as part of its investigation of the circumstances relating to the U.S. Central Federal Credit Union being placed into conservatorship in March 2009, including the U.S. Central Federal Credit Union's investment in various RMBS. The NCUA requested information relating to, among other things, two RMBS (i) issued in 2007 by a securitization trust with respect to which Sequoia Residential Funding, Inc. was the depositor and (ii) purchased at the time of issuance by the U.S. Central Federal Credit Union. We have responded to the subpoena. The subpoena from the NCUA states that it should not be construed as an indication by the NCUA or its staff that any violation of law has occurred. The NCUA could, however, as a result of this investigation or otherwise, allege that we did violate applicable law or regulation in the conduct of our securitization business and, if it was to make such an allegation, it is possible that we might not be successful in defending any related action brought against us and any losses incurred as a result of the resolution of any such action against us could have a material adverse effect on our results of operations in future periods.

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The tables below present the results of Redwood Parent, our 2010 Sequoia securitization, and other consolidated entities and supplement our consolidated GAAP results for the three and six months ended June 30, 2010 and 2009. Other consolidated entities include the Fund, Sequoia entities issued prior to 2010, and Acacia entities that have been consolidated for financial reporting purposes.

**Table 6 Consolidating Income Statements**

| (In Thousands)  | Three Months Ended June 30, 2010 |              |                             |                          |                      |
|---|----------------------------------|--------------|-----------------------------|--------------------------|----------------------|
|   | Redwood Parent                   | 2010 Sequoia | Other Consolidated Entities | Intercompany Adjustments | Redwood Consolidated |
| Interest income   | \$25,547                         | \$ 1,590     | \$ 29,172                   | \$ 261                   | \$ 56,570            |
| Management fees   | 258                              |              |                             | (258 )                   |                      |
| Interest expense  | (2,176 )                         | (1,388 )     | (17,597 )                   | (3 )                     | (21,164 )            |
| Net interest income   | 23,629                           | 202          | 11,575                      |                          | 35,406               |
| Provision for loan losses   |                                  | (12 )        | (4,309 )                    |                          | (4,321 )             |
| Market valuation adjustments, net   | (3,596 )                         |              | (3,529 )                    |                          | (7,125 )             |
| Net interest income (loss) after provision and market valuation adjustments | 20,033                           | 190          | 3,737                       |                          | 23,960               |
| Operating expenses  | (11,153)                         |              | (74 )                       |                          | (11,227 )            |
| Realized gains, net   | 15,791                           |              | 289                         |                          | 16,080               |
| Income from 2010 Sequoia  | 190                              |              |                             | (190 )                   |                      |
| Income from Other Consolidated Entities                                     | 3,766                            |              |                             | (3,766 )                 |                      |
| Noncontrolling interest   |                                  |              | (186 )                      |                          | (186 )               |
| Net income (loss) before provision for taxes                                | 28,627                           | 190          | 3,766                       | (3,956 )                 | 28,627               |
| Provision for income taxes  | (26 )                            |              |                             |                          | (26 )                |
| Net Income (Loss)   | \$28,601                         | \$ 190       | \$ 3,766                    | \$ (3,956 )              | \$ 28,601            |

| (In Thousands)  | Three Months Ended June 30, 2009 |              |                             |                          |                      |
|---|----------------------------------|--------------|-----------------------------|--------------------------|----------------------|
|   | Redwood Parent                   | 2010 Sequoia | Other Consolidated Entities | Intercompany Adjustments | Redwood Consolidated |
| Interest income   | \$20,666                         | \$           | \$ 54,622                   | \$ (1,027 )              | \$ 74,261            |
| Management fees   | 845                              |              |                             | (845 )                   |                      |
| Interest expense  | (1,502 )                         |              | (39,024 )                   | 1,525                    | (39,001 )            |
| Net interest income   | 20,009                           |              | 15,598                      | (347 )                   | 35,260               |
| Provision for loan losses   |                                  |              | (14,545 )                   |                          | (14,545 )            |
| Market valuation adjustments, net   | (31,595)                         |              | 2,460                       |                          | (29,135 )            |
| Net interest (loss) income after provision and market valuation adjustments | (11,586)                         |              | 3,513                       | (347 )                   | (8,420 )             |
| Operating expenses  | (10,710)                         |              | (406 )                      | 347                      | (10,769 )            |
| Realized gains, net   | 6,861                            |              | 18,664                      |                          | 25,525               |

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|  |         |        |           |                     |
|--|---------|--------|-----------|---------------------|
| Income from Other Consolidated Entities      | 21,644  |        | (21,644 ) |                     |
| Noncontrolling interest                      |         | (127 ) |           | (127 )              |
| Net income (loss) before provision for taxes | 6,209   | 21,644 | (21,644 ) | 6,209               |
| Benefit from income taxes                    | 514     |        |           | 514                 |
| Net Income (Loss)                            | \$6,723 | \$     | \$21,644  | \$(21,644 ) \$6,723 |

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| (In Thousands)  | Six Months Ended June 30, 2010 |              |                             |                          |                      |
|---|--------------------------------|--------------|-----------------------------|--------------------------|----------------------|
|   | Redwood Parent                 | 2010 Sequoia | Other Consolidated Entities | Intercompany Adjustments | Redwood Consolidated |
| Interest income   | \$52,848                       | \$ 1,590     | \$ 60,500                   | \$ 350                   | \$ 115,288           |
| Management fees   | 845                            |              |                             | (845 )                   |                      |
| Interest expense  | (3,292 )                       | (1,388 )     | (34,867 )                   | 201                      | (39,346 )            |
| Net interest income   | 50,401                         | 202          | 25,633                      | (294 )                   | 75,942               |
| Provision for loan losses   |                                | (12 )        | (13,785 )                   |                          | (13,797 )            |
| Market valuation adjustments, net   | (6,657 )                       |              | (11,705 )                   |                          | (18,362 )            |
| Net interest income (loss) after provision and market valuation adjustments | 43,744                         | 190          | 143                         | (294 )                   | 43,783               |
| Operating expenses  | (28,360)                       |              | (467 )                      | 294                      | (28,533 )            |
| Realized gains, net   | 54,036                         |              | 6,381                       |                          | 60,417               |
| Income from 2010 Sequoia  | 190                            |              |                             | (190 )                   |                      |
| Income from Other Consolidated Entities                                     | 5,886                          |              |                             | (5,886 )                 |                      |
| Noncontrolling interest   |                                |              | (171 )                      |                          | (171 )               |
| Net income (loss) before provision for taxes                                | 75,496                         | 190          | 5,886                       | (6,076 )                 | 75,496               |
| Provision for income taxes  | (52 )                          |              |                             |                          | (52 )                |
| Net Income (Loss)   | \$75,444                       | \$ 190       | \$ 5,886                    | \$ (6,076 )              | \$ 75,444            |

| (In Thousands)  | Six Months Ended June 30, 2009 |              |                             |                          |                      |
|---|--------------------------------|--------------|-----------------------------|--------------------------|----------------------|
|   | Redwood Parent                 | 2010 Sequoia | Other Consolidated Entities | Intercompany Adjustments | Redwood Consolidated |
| Interest income   | \$42,494                       | \$           | \$ 113,608                  | \$(404 )                 | \$ 155,698           |
| Management fees   | 1,877                          |              |                             | (1,877 )                 |                      |
| Interest expense  | (3,310 )                       |              | (84,908 )                   | 1,576                    | (86,642 )            |
| Net interest income   | 41,061                         |              | 28,700                      | (705 )                   | 69,056               |
| Provision for loan losses   |                                |              | (30,577 )                   |                          | (30,577 )            |
| Market valuation adjustments, net   | (57,882)                       |              | (14,497 )                   |                          | (72,379 )            |
| Net interest (loss) income after provision and market valuation adjustments | (16,821)                       |              | (16,374 )                   | (705 )                   | (33,900 )            |
| Operating expenses  | (21,170)                       |              | (843 )                      | 705                      | (21,308 )            |
| Realized gains, net   | 7,199                          |              | 18,789                      |                          | 25,988               |
| Income from Other Consolidated Entities                                     | 2,161                          |              |                             | (2,161 )                 |                      |
| Noncontrolling interest   |                                |              | 589                         |                          | 589                  |
| Net (loss) income before provision for taxes                                | (28,631)                       |              | 2,161                       | (2,161 )                 | (28,631 )            |
| Benefit from income taxes   | 409                            |              |                             |                          | 409                  |
| Net (Loss) Income   | \$(28,222)                     | \$           | \$ 2,161                    | \$(2,161 )               | \$(28,222 )          |

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The following table presents the net interest income (loss) after market valuation adjustments (MVA) at Redwood for the three and six months ended June 30, 2010 and 2009.

**Table 7 Net Interest Income (Loss) after MVA at Redwood Parent**

| (Dollars in Thousands)                             | Three Months Ended June 30,<br>2010   |                                 |          | 2009                                      |                              |          |
|--|---------------------------------------|---------------------------------|----------|---|------------------------------|----------|
|  | Total<br>Interest<br>Income/(Expense) | Average<br>Amortized<br>Expense | Yield    | Total<br>Interest<br>Income/<br>(Expense) | Average<br>Amortized<br>Cost | Yield    |
| Interest Income                                    |                                       |                                 |          |   |                              |          |
| Real estate loans                                  | \$39                                  | \$2,542                         | 6.14 %   | \$49                                      | \$2,682                      | 7.31 %   |
| Trading securities                                 | 2,559                                 | 17,743                          | 57.69 %  | 872                                       | 4,209                        | 82.87 %  |
| Available-for-sale securities                      | 22,859                                | 651,985                         | 14.03 %  | 19,667                                    | 428,368                      | 18.36 %  |
| Cash and cash equivalents                          | 90                                    | 283,224                         | 0.13 %   | 78  | 227,597                      | 0.14 %   |
| Total Interest Income                              | 25,547                                |                                 |          | 20,666                                    |                              |          |
| Management fees                                    | 258                                   |                                 |          | 845                                       |                              |          |
| Interest Expense                                   |                                       |                                 |          |   |                              |          |
| Short-term debt                                    | (36 )                                 | 7,920                           | (1.81 )% |   |                              |          |
| Long-term debt <sup>(1)</sup>                      | (1,153 )                              | 138,383                         | (3.34 )% | (1,502 )                                  | 147,430                      | (4.08 )% |
| Interest rate agreements <sup>(1)</sup>            | (987 )                                | 138,383                         | (2.85 )% |   |                              |          |
| Total Interest Expense                             | (2,176 )                              |                                 |          | (1,502 )                                  |                              |          |
| Net Interest Income                                | 23,629                                |                                 |          | 20,009                                    |                              |          |
| Market valuation adjustments,<br>net               | (3,596 )                              |                                 |          | (31,595)                                  |                              |          |
| Net Interest Income (Loss)<br>After MVA at Redwood | \$20,033                              |                                 |          | \$(11,586)                                |                              |          |

(1) All interest rates agreement expense relates to cash-flow hedges on long-term debt. The combined expense yield on our hedged long-term debt is 6.19%.

| (Dollars in Thousands)        | Six Months Ended June 30,<br>2010     |                                 |         | 2009                                      |                              |          |
|-------------------------------|---------------------------------------|---------------------------------|---------|---|------------------------------|----------|
|                               | Total<br>Interest<br>Income/(Expense) | Average<br>Amortized<br>Expense | Yield   | Total<br>Interest<br>Income/<br>(Expense) | Average<br>Amortized<br>Cost | Yield    |
| Interest Income               |                                       |                                 |         |   |                              |          |
| Real estate loans             | \$76                                  | \$2,549                         | 5.96 %  | \$113                                     | \$2,765                      | 8.17 %   |
| Trading securities            | 5,515                                 | 19,110                          | 57.72 % | 3,844                                     | 4,934                        | 155.82 % |
| Available-for-sale securities | 47,152                                | 663,245                         | 14.22 % | 38,416                                    | 344,537                      | 22.30 %  |
| Cash and cash equivalents     | 105                                   | 253,979                         | 0.08 %  | 121                                       | 266,235                      | 0.09 %   |

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|  |          |         |          |            |         |          |
|--|----------|---------|----------|------------|---------|----------|
| Total Interest Income                              | 52,848   |         |          | 42,494     |         |          |
| Management fees                                    | 845      |         |          | 1,877      |         |          |
| Interest Expense                                   |          |         |          |            |         |          |
| Short-term debt                                    | (36 )    | 3,982   | (1.80 )% |            |         |          |
| Long-term debt <sup>(1)</sup>                      | (2,269 ) | 138,264 | (3.28 )% | (3,310 )   | 147,312 | (4.49 )% |
| Interest rate agreements <sup>(1)</sup>            | (987 )   | 138,264 | (1.43 )% |            |         |          |
| Total Interest Expense                             | (3,292 ) |         |          | (3,310 )   |         |          |
| Net Interest Income                                | 50,401   |         |          | 41,061     |         |          |
| Market valuation adjustments,<br>net               | (6,657 ) |         |          | (57,882)   |         |          |
| Net Interest Income (Loss)<br>After MVA at Redwood | \$43,744 |         |          | \$(16,821) |         |          |

(1) All interest rates agreement expense relates to cash-flow hedges on long-term debt. The combined expense yield on our hedged long-term debt is 4.71%.

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Net interest income after MVA at Redwood was \$20 million for the three months ended June 30, 2010, as compared to negative \$12 million for the three months ended June 30, 2009, an increase of \$32 million. Net interest income after MVA at Redwood was \$44 million for the six months ended June 30, 2010, as compared to negative \$17 million for the six months ended June 30, 2009, an increase of \$61 million. These differences were primarily due to a significant decline in negative market valuation adjustments during comparable periods due to fewer impairments on subordinate securities. Additionally, interest income from senior residential securities acquired during 2009 more than offset declining interest income from subordinate securities acquired in prior periods. Despite lower benchmark LIBOR rates, total interest expense recognized on our long-term debt increased during the first six month of 2010 as compared to the first six month of 2009, due to additional interest expense on cash flow hedges entered into during the first quarter of 2010.

### Analysis of Interest Income at Redwood Parent

Interest income at Redwood was \$26 million for the three months ended June 30, 2010, as compared to \$21 million for the three months ended June 30, 2009, an increase of \$5 million. Interest income at Redwood was \$53 million for the six months ended June 30, 2010, as compared to \$43 million for the six months ended June 30, 2009, an increase of \$10 million. Increases in balances were partially offset by lower interest rates and yields. The following table details how interest income changed as a result of changes in average investment balances ( volume ) and changes in interest yields ( rate ).

**Table 8 Interest Income at Redwood Parent Volume and Rate Changes**

| (In Thousands)                | Change in Interest Income<br>Three Months Ended June 30, 2010 vs. June<br>30, 2009 |             |              |
|-------------------------------|--|-------------|--------------|
|                               | Volume   | Rate        | Total Change |
| Real estate loans             | \$ (45 )   | \$ 35       | \$ (10 )     |
| Trading securities            | 2,682  | (995 )      | 1,687        |
| Available-for-sale securities | 10,258   | (7,066 )    | 3,192        |
| Cash and cash equivalents     | 19   | (7 )        | 12           |
| Total Interest Income         | \$ 12,914  | \$ (8,033 ) | \$ 4,881     |

| (In Thousands)                | Change in Interest Income<br>Six Months Ended June 30, 2010 vs. June<br>30, 2009 |              |              |
|-------------------------------|--|--------------|--------------|
|                               | Volume   | Rate         | Total Change |
| Real estate loans             | \$ (106 )  | \$ 69        | \$ (37 )     |
| Trading securities            | (1,384 )   | 3,055        | 1,671        |
| Available-for-sale securities | 32,535   | (23,799 )    | 8,736        |
| Cash and cash equivalents     | 28   | (44 )        | (16 )        |
| Total Interest Income         | \$ 31,073  | \$ (20,719 ) | \$ 10,354    |

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We classify most senior, re-REMIC, and subordinate securities as available-for-sale (AFS) securities under GAAP. The following table presents the components of the interest income we earned on AFS securities for the three and six months ended June 30, 2010 and 2009.

**Table 9 Interest Income AFS Securities at Redwood Parent**

| Three Months Ended June 30, 2010 |                 |                                 |                       |                        | Yield as a Result of <sup>(1)</sup> |                                 |                       |
|----------------------------------|-----------------|---------------------------------|-----------------------|------------------------|-------------------------------------|---------------------------------|-----------------------|
| (Dollars in Thousands)           | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Interest Income                     | Discount (Premium) Amortization | Total Interest Income |
| Senior Residential               | \$6,954         | \$9,922                         | \$16,876              | \$564,933              | 4.92 %                              | 7.03 %                          | 11.95 %               |
| Re-REMIC Residential             | 1,866           | (484 )                          | 1,382                 | 34,385                 | 21.71 %                             | (5.63) %                        | 16.08 %               |
| Subordinate                      |                 |                                 |                       |                        |                                     |                                 |                       |
| Residential                      | 3,427           | 396                             | 3,823                 | 45,250                 | 30.29 %                             | 3.50 %                          | 33.79 %               |
| Commercial                       | 666             | 30                              | 696                   | 7,417                  | 35.92 %                             | 1.62 %                          | 37.54 %               |
| CDO                              | 107             | (25 )                           | 82                    |                        | N/A                                 | N/A                             | N/A                   |
| Total Subordinate                | 4,200           | 401                             | 4,601                 | 52,667                 | 31.90 %                             | 3.05 %                          | 34.95 %               |
| Total AFS Securities             | \$13,020        | \$9,839                         | \$22,859              | \$651,985              | 7.99 %                              | 6.04 %                          | 14.03 %               |

| Three Months Ended June 30, 2009 |                 |                                 |                       |                        | Yield as a Result of <sup>(1)</sup> |                                 |                       |
|----------------------------------|-----------------|---------------------------------|-----------------------|------------------------|-------------------------------------|---------------------------------|-----------------------|
| (Dollars in Thousands)           | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Interest Income                     | Discount (Premium) Amortization | Total Interest Income |
| Senior Residential               | \$5,808         | \$6,274                         | \$12,082              | \$332,066              | 7.00 %                              | 7.56 %                          | 14.56 %               |
| Re-REMIC Residential             | 560             | 13                              | 573                   | 26,419                 | 8.48 %                              | 0.20 %                          | 8.68 %                |
| Subordinate                      |                 |                                 |                       |                        |                                     |                                 |                       |
| Residential                      | 7,268           | (1,951)                         | 5,317                 | 44,856                 | 64.81 %                             | (17.40) %                       | 47.41 %               |
| Commercial                       | 3,387           | (1,788)                         | 1,599                 | 25,006                 | 54.18 %                             | (28.60) %                       | 25.58 %               |
| CDO                              | 121             | (25 )                           | 96                    | 21                     | N/A                                 | N/A                             | N/A                   |
| Total Subordinate                | 10,776          | (3,764)                         | 7,012                 | 69,883                 | 61.68 %                             | (21.54) %                       | 40.14 %               |
| Total AFS Securities             | \$17,144        | \$2,523                         | \$19,667              | \$428,368              | 16.01 %                             | 2.36 %                          | 18.37 %               |

| Six Months Ended June 30, 2010 |                 |                                 |                       |                        | Yield as a Result of <sup>(1)</sup> |                                 |                       |
|--------------------------------|-----------------|---------------------------------|-----------------------|------------------------|-------------------------------------|---------------------------------|-----------------------|
| (Dollars in Thousands)         | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Interest Income                     | Discount (Premium) Amortization | Total Interest Income |
| Senior Residential             | \$15,016        | \$20,525                        | \$35,541              | \$570,280              | 5.27 %                              | 7.20 %                          | 12.47 %               |
| Re-REMIC Residential           | 4,442           | (1,135 )                        | 3,307                 | 40,087                 | 22.16 %                             | (5.66) %                        | 16.50 %               |
| Subordinate                    |                 |                                 |                       |                        |                                     |                                 |                       |
| Residential                    | 6,656           | 142                             | 6,798                 | 45,335                 | 29.36 %                             | 0.63 %                          | 29.99 %               |
| Commercial                     | 1,701           | (289 )                          | 1,412                 | 7,543                  | 45.10 %                             | (7.66) %                        | 37.44 %               |
| CDO                            | 145             | (51 )                           | 94                    |                        | N/A                                 | N/A                             | N/A                   |
| Total Subordinate              | 8,502           | (198 )                          | 8,304                 | 52,878                 | 32.16 %                             | (0.75) %                        | 31.41 %               |
| Total AFS Securities           | \$27,960        | \$19,192                        | \$47,152              | \$663,245              | 8.43 %                              | 5.79 %                          | 14.22 %               |

Six Months Ended June 30, 2009

| (Dollars in Thousands)              | Interest<br>Income | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income | Average<br>Amortized<br>Cost | Yield as a Result of <sup>(1)</sup> |                                       |                             |
|-------------------------------------|--------------------|---------------------------------------|-----------------------------|------------------------------|-------------------------------------|---------------------------------------|-----------------------------|
|                                     |                    |                                       |                             |                              | Interest<br>Income                  | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income |
| Senior Residential                  | \$8,595            | \$9,596                               | \$18,191                    | 248,596                      | 6.91 %                              | 7.72 %                                | 14.63 %                     |
| Re-REMIC Residential<br>Subordinate | 560                | 13                                    | 573                         | 13,282                       | 8.43 %                              | 0.20 %                                | 8.63 %                      |
| Residential                         | 15,959             | 1,489                                 | 17,448                      | 47,001                       | 67.91 %                             | 6.34 %                                | 74.25 %                     |
| Commercial                          | 7,937              | (5,838)                               | 2,099                       | 35,635                       | 44.55 %                             | (32.77)%                              | 11.78 %                     |
| CDO                                 | 131                | (25 )                                 | 106                         | 23                           | N/A                                 | N/A                                   | N/A                         |
| Total Subordinate                   | 24,027             | (4,374)                               | 19,653                      | 82,659                       | 58.14 %                             | 10.58 %                               | 47.56 %                     |
| Total AFS Securities                | \$33,182           | \$5,235                               | \$38,417                    | \$344,537                    | 19.26 %                             | 3.04 %                                | 22.30 %                     |

Cash flow from many of our subordinate securities can be volatile and in certain cases (e.g., when the fair values of (1) certain securities are close to zero) any interest income earned can result in unusually high reported yields that are not sustainable and not necessarily meaningful.

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TABLE OF CONTENTS**Analysis of Interest Expense at Redwood Parent**

Interest expense at Redwood was \$2 million for the three months ended June 30, 2010, as compared to \$1 million for the three months ended June 30, 2009, an increase of \$1 million, primarily as a result of interest expense recognized on cash flow hedges entered into during the first quarter of 2010 to hedge interest rate exposure on our long-term debt, partially offset by lower short-term interest rates, as well as lower average debt balances as a result of the extinguishment of \$10 million of long-term debt during 2009. Interest expense at Redwood was \$3 million for both the six months ended June 30, 2010 and 2009.

The following table details how interest expense changed as a result of changes in average investment balances ( volume ) and changes in interest yields ( rate ).

**Table 10 Interest Expense at Redwood Parent Volume and Rate Changes**

| (In Thousands)         | Change in Interest Expense<br>Three Months Ended June 30, 2010 vs. June<br>30, 2009 |        |              |
|------------------------|---|--------|--------------|
|                        | Volume  | Rate   | Total Change |
| Short-term debt        | \$ 36   | \$     | \$ 36        |
| Long-term debt         | (92 )   | 730    | 638          |
| Total Interest Expense | \$ (56 )  | \$ 730 | \$ 674       |

| (In Thousands)         | Change in Interest Expense<br>Six Months Ended June 30, 2010 vs. June<br>30, 2009 |        |              |
|------------------------|---|--------|--------------|
|                        | Volume  | Rate   | Total Change |
| Short-term debt        | \$ 36   | \$     | \$ 36        |
| Long-term debt         | (203 )  | 149    | (54 )        |
| Total Interest Expense | \$ (167 )   | \$ 149 | \$ (18 )     |

**Market Valuation Adjustments at Redwood Parent**

The following table presents the impact of market valuation adjustments at Redwood for the three and six months ended June 30, 2010 and 2009.

**Table 11 Impact of Market Valuation Adjustments at Redwood Parent**

| (In Thousands)                                 | Three Months Ended<br>June 30, |              | Six Months Ended June 30, |              |
|--|--------------------------------|--------------|---------------------------|--------------|
|  | 2010                           | 2009         | 2010                      | 2009         |
| Change in fair value of assets and liabilities | \$ (233 )                      | \$ 473       | \$ (1,729 )               | \$ (668 )    |
| Impairment on AFS securities                   | (3,363 )                       | (32,068 )    | (4,928 )                  | (57,214 )    |
| Total Market Valuation Adjustments, Net        | \$ (3,596 )                    | \$ (31,595 ) | \$ (6,657 )               | \$ (57,882 ) |

At Redwood, we classify most securities as AFS and report unrealized gains and losses, and other-than-temporary impairments (OTTI) related to non-credit factors, as a component of stockholders equity in our consolidated balance

sheet. Conversely, OTTI related to credit factors, and market valuation adjustments on derivatives and trading securities, are recorded through our income statement.

For the second quarter of 2010, we recognized an aggregate \$6 million of OTTI at Redwood. Of this amount, \$3 million was related to credit factors and recognized in our consolidated statement of income, and the remaining \$3 million was recognized as a reduction in stockholders' equity. For the second quarter of 2009, we recognized an aggregate \$38 million of OTTI at Redwood. Unrealized losses on securities and OTTI related to non-credit factors totaled less than \$1 million for the second quarter of 2010 and \$8 million for the second quarter of 2009, net of a negative \$58 million of one-time adjustments related to the new accounting guidance for OTTI. To the extent our loss expectations do not significantly change, we expect the pace of future impairments on securities to remain near levels observed in recent quarters.

For the first half of 2010, we recognized an aggregate \$9 million of OTTI at Redwood. Of this amount, \$5 million was related to credit factors and recognized in our consolidated statement of income, and the remaining \$4 million was recognized as a reduction in stockholders' equity. For the first half of 2009, we

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recognized an aggregate \$63 million of OTTI at Redwood. Unrealized losses on securities and OTTI related to non-credit factors totaled \$10 million for the first half of 2010 and negative \$20 million for the first half of 2009, net of a negative \$58 million of one-time adjustments related to the new accounting guidance for OTTI.

## Operating Expenses at Redwood and Consolidated Entities

The following table presents the components of operating expenses for the three and six months ended June 30, 2010 and 2009.

### Table 12 Operating Expenses

| (In Thousands)                | Three Months Ended<br>June 30, |           | Six Months Ended June<br>30, |           |
|-------------------------------|--------------------------------|-----------|------------------------------|-----------|
|                               | 2010                           | 2009      | 2010                         | 2009      |
| Fixed compensation expense    | \$ 3,661                       | \$ 3,572  | \$ 7,770                     | \$ 7,600  |
| Variable compensation expense | 1,303                          | 1,132     | 3,183                        | 1,688     |
| Equity compensation expense   | 2,077                          | 2,337     | 8,136                        | 4,132     |
| Severance expense             | 229                            |           | 310                          | 28        |
| Total compensation expense    | 7,270                          | 7,041     | 19,399                       | 13,448    |
| Systems                       | 1,734                          | 1,233     | 3,311                        | 2,826     |
| Office costs                  | 1,783                          | 1,675     | 3,548                        | 3,426     |
| Accounting and legal          | 45                             | 421       | 1,511                        | 980       |
| Other operating expenses      | 395                            | 399       | 764                          | 628       |
| Total Operating Expenses      | \$ 11,227                      | \$ 10,769 | \$ 28,533                    | \$ 21,308 |

Operating expenses were \$11 million for the three months ended June 30, 2010 and 2009. Operating expenses were \$29 million and \$21 million for the six months ended June 30, 2010 and 2009, respectively. This increase was primarily due to a \$4 million non-recurring equity compensation expense related to the accelerated vesting of equity awards from the announced retirement of our former Chief Executive Officer. The remaining increase was the result of a rise in our operating expenses associated with the expansion of our residential securitization business and an increase in our variable compensation expense. We currently expect our quarterly operating costs in 2010 to remain generally consistent with the expenses in the first half of 2010 (excluding the non-recurring charge noted above).

## Gains and Losses at Redwood and Consolidated Entities

The following table details the components of realized gains on sales of investments, net, for the three and six months ended June 30, 2010 and 2009.

### Table 13 Realized Gains, Net

| (In Thousands)                               | Three Months Ended<br>June 30, |          | Six Months Ended June 30, |          |
|--|--------------------------------|----------|---------------------------|----------|
|  | 2010                           | 2009     | 2010                      | 2009     |
| Net gains on sales of real estate securities | \$ 15,811                      | \$ 6,861 | \$ 53,189                 | \$ 7,199 |
| Net gains on repurchase of Sequoia ABS       |                                |          | 6,959                     |          |
| Net gains on extinguishment of debt          | 278                            | 93       | 278                       | 218      |

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|                               |           |           |           |           |
|-------------------------------|-----------|-----------|-----------|-----------|
| Net losses on U.S. Treasuries | (9 )      |           | (9 )      |           |
| Gains on deconsolidation      |           | 18,571    |           | 18,571    |
| Total Realized Gains, Net     | \$ 16,080 | \$ 25,525 | \$ 60,417 | \$ 25,988 |

Realized gains of \$16 million for the three months ended June 30, 2010, reflect \$16 million in gains on the sales of securities as part of our ongoing portfolio management activities. Realized gains of \$60 million for the six months ended June 30, 2010, reflect \$53 million in gains on the sales of securities as part of our ongoing portfolio management activities and the repurchase of \$15 million of Sequoia ABS at a significant discount to the principal amount owed, resulting in a \$7 million gain.

TABLE OF CONTENTS**Results of Operations 2010 Sequoia Securitization Entity**

The following table presents the net interest income at our 2010 Sequoia securitization entity for the three months ended June 30, 2010.

**Table 14 Net Interest Income at 2010 Sequoia Securitization Entity**

| Three Months Ended June 30, 2010<br>(Dollars in Thousands) | Interest<br>Income/<br>(Expense) | Premium<br>Amortization <sup>(1)</sup> | Total<br>Interest<br>Income/<br>(Expense) | Average<br>Amortized<br>Cost | Yield   |
|--|----------------------------------|--|---|------------------------------|---------|
| Interest Income  |                                  |  |   |                              |         |
| Residential real estate loans                              | \$ 1,828                         | \$ (238 )                              | \$ 1,590                                  | \$ 161,502                   | 3.94 %  |
| Total Interest Income                                      | 1,828                            | (238 )                                 | 1,590                                     |                              |         |
| Interest Expense   |                                  |  |   |                              |         |
| ABS issued <sup>(1)</sup>                                  | (1,338 )                         | (50 )                                  | (1,388 )                                  | 144,201                      | (3.85)% |
| Total Interest Expense                                     | (1,338 )                         | (50 )                                  | (1,388 )                                  |                              |         |
| Net Interest Income  | \$ 490                           | \$ (288 )                              | \$ 202                                    |                              |         |

(1) All Sequoia ABS premium amortization is related to DBIC amortization.

Net interest income at our 2010 Sequoia securitization was \$202 thousand for the three months ended June 30, 2010. Our loan loss provision for the same period was \$12 thousand.

**Results of Operations Other Consolidated Entities**

The following table presents the net interest income at our other consolidated entities for the three and six months ended June 30, 2010 and 2009.

**Table 15 Net Interest Income at Other Consolidated Entities**

| Three Months Ended June 30, 2010<br>(Dollars in Thousands) | Interest<br>Income/<br>(Expense) | (Premium)<br>Discount<br>Amortization <sup>(1)</sup> | Total<br>Interest<br>Income/<br>(Expense) | Average<br>Amortized<br>Cost | Yield    |
|--|----------------------------------|--|---|------------------------------|----------|
| Interest Income  |                                  |  |   |                              |          |
| Residential real estate loans                              | \$ 15,871                        | \$ (1,747 )  | \$ 14,124                                 | \$ 3,589,882                 | 1.57 %   |
| Commercial real estate loans                               | 262                              |  | 262                                       | 17,588                       | 5.96 %   |
| Trading securities   | 13,483                           |  | 13,483                                    | 264,439                      | 20.39 %  |
| Available-for-sale securities                              | 314                              | 982  | 1,296                                     | 35,526                       | 14.59 %  |
| Other investments  | 4                                |  | 4   | 8,032                        | 0.20 %   |
| Cash and cash equivalents                                  | 3                                |  | 3   | 55,910                       | 0.02 %   |
| Total Interest Income                                      | 29,937                           | (765 )   | 29,172                                    |                              |          |
| Interest Expense   |                                  |  |   |                              |          |
| ABS issued Sequoia <sup>(1)</sup>                          | (8,662 )                         | (153 )   | (8,815 )                                  | 3,518,773                    | (1.00 )% |
| ABS issued Acacia  | (7,655 )                         |  | (7,655 )                                  | 268,715                      | (11.39)% |



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|                          |         |           |           |           |           |          |
|--------------------------|---------|-----------|-----------|-----------|-----------|----------|
| Interest rate agreements | Sequoia | (62 )     |           | (62 )     | 3,518,773 | (0.01 )% |
| Interest rate agreements | Acacia  | (1,065 )  |           | (1,065 )  | 268,715   | (1.59 )% |
| Total Interest Expense   |         | (17,444 ) | (153 )    | (17,597 ) |           |          |
| Net Interest Income      |         | \$ 12,493 | \$ (918 ) | \$ 11,575 |           |          |

(1) Sequoia ABS premium amortization includes \$196 thousand of bond issuance premium amortization and negative \$349 thousand of DBIC amortization.

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| Three Months Ended June 30, 2009  | Interest             | (Premium)                               | Total                            | Average           | Yield    |
|-----------------------------------|----------------------|---|----------------------------------|-------------------|----------|
| (Dollars in Thousands)            | Income/<br>(Expense) | Discount<br>Amortization <sup>(1)</sup> | Interest<br>Income/<br>(Expense) | Amortized<br>Cost |          |
| <b>Interest Income</b>            |                      |   |                                  |                   |          |
| Residential real estate loans     | \$ 34,158            | \$ (3,989 )                             | \$ 30,169                        | \$4,305,159       | 2.80 %   |
| Commercial real estate loans      | 396                  |   | 396                              | 9,005             | 17.59 %  |
| Trading securities                | 22,115               |   | 22,115                           | 255,511           | 34.62 %  |
| Available-for-sale securities     | 508                  | 1,340                                   | 1,848                            | 58,054            | 12.73 %  |
| Other investments                 | 55                   |   | 55                               | 56,690            | 0.39 %   |
| Cash and cash equivalents         | 39                   |   | 39                               | 55,105            | 0.28 %   |
| <b>Total Interest Income</b>      | <b>57,271</b>        | <b>(2,649 )</b>                         | <b>54,622</b>                    |                   |          |
| <b>Interest Expense</b>           |                      |   |                                  |                   |          |
| ABS issued Sequoia <sup>(1)</sup> | (23,165 )            | (199 )                                  | (23,364 )                        | 4,211,937         | (2.22 )% |
| ABS issued Acacia                 | (14,550 )            |   | (14,550 )                        | 285,698           | (20.37)% |
| Interest rate agreements Sequoia  | (21 )                |   | (21 )                            | 4,211,937         | (0.00 )% |
| Interest rate agreements Acacia   | (1,089 )             |   | (1,089 )                         | 285,698           | (1.52 )% |
| <b>Total Interest Expense</b>     | <b>(38,825 )</b>     | <b>(199 )</b>                           | <b>(39,024 )</b>                 |                   |          |
| <b>Net Interest Income</b>        | <b>\$ 18,446</b>     | <b>\$ (2,848 )</b>                      | <b>\$ 15,598</b>                 |                   |          |

(1) Sequoia ABS premium amortization includes \$313 thousand of bond issuance premium amortization and negative \$512 thousand of DBIC amortization.

| Six Months Ended June 30, 2010    | Interest             | (Premium)                               | Total                            | Average           | Yield    |
|-----------------------------------|----------------------|---|----------------------------------|-------------------|----------|
| (Dollars in Thousands)            | Income/<br>(Expense) | Discount<br>Amortization <sup>(1)</sup> | Interest<br>Income/<br>(Expense) | Amortized<br>Cost |          |
| <b>Interest Income</b>            |                      |   |                                  |                   |          |
| Residential real estate loans     | \$ 32,702            | \$ (4,118 )                             | \$ 28,584                        | \$3,628,170       | 1.58 %   |
| Commercial real estate loans      | 558                  |   | 558                              | 15,680            | 7.12 %   |
| Trading securities                | 28,455               |   | 28,455                           | 265,949           | 21.40 %  |
| Available-for-sale securities     | 627                  | 2,258                                   | 2,885                            | 38,811            | 14.87 %  |
| Other investments                 | 13                   |   | 13                               | 13,295            | 0.20 %   |
| Cash and cash equivalents         | 5                    |   | 5                                | 68,135            | 0.01 %   |
| <b>Total Interest Income</b>      | <b>62,360</b>        | <b>(1,860 )</b>                         | <b>60,500</b>                    |                   |          |
| <b>Interest Expense</b>           |                      |   |                                  |                   |          |
| ABS issued Sequoia <sup>(1)</sup> | (17,836 )            | (331 )                                  | (18,167 )                        | 3,553,827         | (1.02 )% |
| ABS issued Acacia                 | (15,078 )            |   | (15,078 )                        | 278,424           | (10.83)% |
| Interest rate agreements Sequoia  | 77                   |   | 77                               | 3,553,827         | 0.00 %   |
| Interest rate agreements Acacia   | (1,699 )             |   | (1,699 )                         | 278,424           | (1.22 )% |
| <b>Total Interest Expense</b>     | <b>(34,536 )</b>     | <b>(331 )</b>                           | <b>(34,867 )</b>                 |                   |          |
| <b>Net Interest Income</b>        | <b>\$ 27,824</b>     | <b>\$ (2,191 )</b>                      | <b>\$ 25,633</b>                 |                   |          |

(1) Sequoia ABS premium amortization includes \$404 thousand of bond issuance premium amortization and negative \$735 thousand of DBIC amortization.



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| Six Months Ended June 30, 2009<br>(Dollars in Thousands) | Interest<br>Income/<br>(Expense) | (Premium)<br>Discount<br>Amortization <sup>(1)</sup> | Total<br>Interest<br>Income/<br>(Expense) | Average<br>Amortized<br>Cost | Yield    |
|--|----------------------------------|--|---|------------------------------|----------|
| <b>Interest Income</b>                                   |                                  |  |   |                              |          |
| Residential real estate loans                            | \$ 75,250                        | \$ (11,448 )   | \$ 63,802                                 | \$4,435,959                  | 2.88 %   |
| Commercial real estate loans                             | 668                              |  | 668                                       | 10,068                       | 13.27 %  |
| Trading securities                                       | 44,218                           |  | 44,218                                    | 286,630                      | 30.85 %  |
| Available-for-sale securities                            | 1,118                            | 3,545  | 4,663                                     | 60,174                       | 15.50 %  |
| Other investments  | 131                              |  | 131                                       | 65,973                       | 0.40 %   |
| Cash and cash equivalents                                | 126                              |  | 126                                       | 47,417                       | 0.53 %   |
| <b>Total Interest Income</b>                             | <b>121,511</b>                   | <b>(7,903 )</b>                                      | <b>113,608</b>                            |                              |          |
| <b>Interest Expense</b>                                  |                                  |  |   |                              |          |
| ABS issued Sequoia <sup>(1)</sup>                        | (48,039 )                        | (417 )   | (48,456 )                                 | 4,336,449                    | (2.23 )% |
| ABS issued Acacia  | (34,244 )                        |  | (34,244 )                                 | 305,646                      | (22.41)% |
| Interest rate agreements Sequoia                         | (42 )                            |  | (42 )                                     | 4,336,449                    | (0.00 )% |
| Interest rate agreements Acacia                          | (2,166 )                         |  | (2,166 )                                  | 305,646                      | (1.42 )% |
| <b>Total Interest Expense</b>                            | <b>(84,491 )</b>                 | <b>(417 )</b>  | <b>(84,908 )</b>                          |                              |          |
| <b>Net Interest Income</b>                               | <b>\$ 37,020</b>                 | <b>\$ (8,320 )</b>                                   | <b>\$ 28,700</b>                          |                              |          |

(1) Sequoia ABS premium amortization includes \$648 thousand of bond issuance premium amortization and negative \$1 million of DBIC amortization.

Net interest income at the other consolidated entities was \$12 million for the three months ended June 30, 2010, as compared to \$16 million for the three months ended June 30, 2009, a decrease of \$4 million. Net interest income at the other consolidated entities was \$26 million for the six months ended June 30, 2010, as compared to \$29 million for the six months ended June 30, 2009, a decrease of \$3 million. The decrease was primarily due to the amount and timing of changes between income yields on securities and loans and expense yields on ABS issued. These changes were largely due to changes in benchmark LIBOR interest rates. Overall interest income and interest expense declined during these periods due to lower average balances of loans, securities, and ABS issued.

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The following table presents the components of the interest income we earned on securities at the Fund in the three and six months ended June 30, 2010 and 2009, which are all accounted for as available-for-sale.

**Table 16 Interest Income Securities at the Fund**

## Three Months Ended June 30, 2010

| (Dollars in Thousands)         | Interest Income | Discount Amortization | Total Interest Income | Average Amortized Cost | Yield as a Result of |                       |   | Total Interest Income |
|--------------------------------|-----------------|-----------------------|-----------------------|------------------------|----------------------|-----------------------|---|-----------------------|
|                                |                 |                       |                       |                        | Interest Income      | Discount Amortization | % |                       |
| Senior Residential Subordinate | \$ 100          | \$ 519                | \$ 619                | \$ 17,354              | 2.31 %               | 11.96 %               |   | 14.27 %               |
| Residential                    | 59              | 126                   | 186                   | 6,329                  | 3.75 %               | 7.99 %                |   | 11.74 %               |
| CDO                            | 154             | 337                   | 491                   | 11,843                 | 5.21 %               | 11.39 %               |   | 16.60 %               |
| Total Subordinate              | 213             | 463                   | 677                   | 18,172                 | 4.70 %               | 10.19 %               |   | 14.89 %               |
| Total AFS Securities           | \$ 313          | \$ 982                | \$ 1,296              | \$ 35,526              | 3.52 %               | 11.05 %               |   | 14.57 %               |

## Three Months Ended June 30, 2009

| (Dollars in Thousands)         | Interest Income | Discount Amortization | Total Interest Income | Average Amortized Cost | Yield as a Result of |                       |   | Total Interest Income |
|--------------------------------|-----------------|-----------------------|-----------------------|------------------------|----------------------|-----------------------|---|-----------------------|
|                                |                 |                       |                       |                        | Interest Income      | Discount Amortization | % |                       |
| Senior Residential Subordinate | \$ 186          | \$ 1,008              | \$ 1,194              | \$ 36,255              | 2.05 %               | 11.12 %               |   | 13.17 %               |
| Residential                    | 81              | 201                   | 282                   | 11,145                 | 2.91 %               | 7.21 %                |   | 10.12 %               |
| CDO                            | 240             | 132                   | 372                   | 10,654                 | 9.01 %               | 4.96 %                |   | 13.97 %               |
| Total Subordinate              | 321             | 333                   | 654                   | 21,799                 | 5.89 %               | 6.11 %                |   | 12.00 %               |
| Total AFS Securities           | \$ 507          | \$ 1,341              | \$ 1,848              | \$ 58,054              | 3.49 %               | 9.24 %                |   | 12.73 %               |

## Six Months Ended June 30, 2010

| (Dollars in Thousands)         | Interest Income | Discount Amortization | Total Interest Income | Average Amortized Cost | Yield as a Result of |                       |   | Total Interest Income |
|--------------------------------|-----------------|-----------------------|-----------------------|------------------------|----------------------|-----------------------|---|-----------------------|
|                                |                 |                       |                       |                        | Interest Income      | Discount Amortization | % |                       |
| Senior Residential Subordinate | \$ 214          | \$ 1,249              | \$ 1,463              | \$ 20,534              | 2.09 %               | 12.17 %               |   | 14.26 %               |
| Residential                    | 117             | 293                   | 411                   | 6,606                  | 3.55 %               | 8.88 %                |   | 12.43 %               |
| CDO                            | 296             | 715                   | 1,011                 | 11,671                 | 5.07 %               | 12.26 %               |   | 17.33 %               |
| Total Subordinate              | 413             | 1,008                 | 1,422                 | 18,277                 | 4.52 %               | 11.03 %               |   | 15.55 %               |
| Total AFS Securities           | \$ 627          | \$ 2,257              | \$ 2,885              | \$ 38,811              | 3.23 %               | 11.63 %               |   | 14.86 %               |

## Six Months Ended June 30, 2009

| (Dollars in Thousands) | Interest Income | Discount Amortization | Total Interest Income | Average Amortized Cost | Yield as a Result of |                       |   | Total Interest Income |
|------------------------|-----------------|-----------------------|-----------------------|------------------------|----------------------|-----------------------|---|-----------------------|
|                        |                 |                       |                       |                        | Interest Income      | Discount Amortization | % |                       |
| Senior Residential     | \$ 393          | \$ 2,816              | \$ 3,209              | \$ 36,429              | 2.16 %               | 15.46 %               |   | 17.62 %               |

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|                      |          |          |          |           |       |       |   |         |
|----------------------|----------|----------|----------|-----------|-------|-------|---|---------|
| Subordinate          |          |          |          |           |       |       |   |         |
| Residential          | 167      | 488      | 655      | 11,535    | 2.90% | 8.46  | % | 11.36 % |
| CDO                  | 557      | 242      | 799      | 12,210    | 9.12% | 3.96  | % | 13.08 % |
| Total Subordinate    | 724      | 730      | 1,454    | 23,745    | 6.10% | 6.15  | % | 12.25 % |
| Total AFS Securities | \$ 1,117 | \$ 3,546 | \$ 4,663 | \$ 60,174 | 3.71% | 11.79 | % | 15.50 % |

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TABLE OF CONTENTS**Analysis of Interest Income at Other Consolidated Entities**

Interest income at our other consolidated entities was \$29 million for the three months ended June 30, 2010, as compared to \$55 million for the three months ended June 30, 2009, a decline of \$26 million. Interest income at our consolidated entities was \$61 million for the six months ended June 30, 2010, as compared to \$114 million for the six months ended June 30, 2009, a decline of \$53 million. Interest income declined primarily due to lower benchmark LIBOR interest rates on loans and securities along with lower average balances at our consolidated entities. Average balances of loans at consolidated Sequoia entities decreased due to principal repayments on loans and securities with no offsetting acquisition activity. The average prepayment rate for loans at consolidated Sequoia entities loans was 8% during the second quarter of 2010 as compared to 11% in the second quarter of 2009. Average balances of loans at consolidated Sequoia entities also decreased due to the deconsolidation of certain Sequoia entities during the past twelve months.

The following table details how interest income changed as a result of changes in average investment balances ( volume ) and changes in interest yields ( rate ) at our other consolidated entities.

**Table 17 Interest Income at Other Consolidated Entities Volume and Rate Changes**

| (In Thousands)                | Change in Interest Income<br>Three Months Ended June 30, 2010 vs. June<br>30, 2009 |              |              |
|-------------------------------|--|--------------|--------------|
|                               | Volume   | Rate         | Total Change |
| Residential real estate loans | \$ (5,012 )  | \$ (11,033 ) | \$ (16,045 ) |
| Commercial real estate loans  | 377  | (511 )       | (134 )       |
| Trading securities            | 773  | (9,405 )     | (8,632 )     |
| Available-for-sale securities | (717 )   | 165          | (552 )       |
| Other investments             | (47 )  | (4 )         | (51 )        |
| Cash and cash equivalents     | 1  | (37 )        | (36 )        |
| Total Interest Income         | \$ (4,625 )  | \$ (20,825 ) | \$ (25,450 ) |

| (In Thousands)                | Change in Interest Income<br>Six Months Ended June 30, 2010 vs. June<br>30, 2009 |              |              |
|-------------------------------|--|--------------|--------------|
|                               | Volume   | Rate         | Total Change |
| Residential real estate loans | \$ (11,618 )   | \$ (23,600 ) | \$ (35,218 ) |
| Commercial real estate loans  | 372  | (482 )       | (110 )       |
| Trading securities            | (3,190 )   | (12,573 )    | (15,763 )    |
| Available-for-sale securities | (1,655 )   | (123 )       | (1,778 )     |
| Other investments             | (105 )   | (13 )        | (118 )       |
| Cash and cash equivalents     | 55   | (176 )       | (121 )       |
| Total Interest Income         | \$ (16,141 )   | \$ (36,967 ) | \$ (53,108 ) |

TABLE OF CONTENTS**Analysis of Interest Expense at Other Consolidated Entities**

Interest expense at our consolidated entities was \$18 million and \$35 million for the three and six months ended June 30, 2010, respectively, as compared to \$39 million and \$85 million for the three and six months ended June 30, 2009, respectively. Interest expense declined primarily due to lower average balances of ABS issued at our securitization entities along with lower benchmark LIBOR interest rates on obligations of consolidated securitization entities. The following table details how interest expense at our consolidated entities changed as a result of changes in average debt balances ( volume ) and interest yields ( rate ).

**Table 18 Interest Expense at Other Consolidated Entities Volume and Rate Changes**

| (In Thousands)         | Change in Interest Expense<br>Three Months Ended June 30, 2010 vs. June<br>30, 2009 |              |              |
|------------------------|---|--------------|--------------|
|                        | Volume  | Rate         | Total Change |
| ABS Issued Sequoia     | \$ (3,848 )   | \$ (10,660 ) | \$ (14,508 ) |
| ABS Issued Acacia      | (930 )  | (5,989 )     | (6,919 )     |
| Total Interest Expense | \$ (4,778 )   | \$ (16,649 ) | \$ (21,427 ) |

| (In Thousands)         | Change in Interest Expense<br>Six Months Ended June 30, 2010 vs. June<br>30, 2009 |              |              |
|------------------------|---|--------------|--------------|
|                        | Volume  | Rate         | Total Change |
| ABS Issued Sequoia     | \$ (8,753 )   | \$ (21,655 ) | \$ (30,408 ) |
| ABS Issued Acacia      | (3,243 )  | (16,390 )    | (19,633 )    |
| Total Interest Expense | \$ (11,996 )  | \$ (38,045 ) | \$ (50,041 ) |

**Loan Loss Provision at Sequoia**

The provision for loan losses was \$4 million for the three months ended June 30, 2010, as compared to \$15 million for the three months ended June 30, 2009. Our \$4 million provision for loans losses was offset by \$4 million (or 0.11% of outstanding loan balances) of net charge-offs in the second quarter of 2010. In the second quarter of 2009, the provision for loan losses exceeded net charge-offs of \$2 million (or 0.05% of outstanding loan balances). These charge-offs were generated by \$13 million and \$8 million of defaulted loans in the three months ended June 30, 2010 and 2009, respectively, for average implied loss severities of 31% and 23% for the three months ended June 30, 2010 and 2009, respectively. This resulted in an increase of less than \$1 million and a decrease of \$2 million in our allowance for loan losses for the three months ended June 30, 2010 and 2009, respectively. There are currently four Sequoia entities for which we have expensed aggregate loan loss provisions of \$2 million in excess of our reported investment for GAAP purposes.

The provision for loan losses was \$14 million for the six months ended June 30, 2010, as compared to \$31 million for the six months ended June 30, 2009. The provision for loan losses exceeded net charge-offs of \$7 million (or 0.17% of outstanding loan balances) and \$6 million (or 0.14% of outstanding loan balances) for the six months ended June 30, 2010 and 2009, respectively. These charge-offs were generated by \$21 million and \$23 million of defaulted loans in the six months ended June 30, 2010 and 2009, respectively, for average implied loss severities of 31% and 25% for



the six months ended June 30, 2010 and 2009, respectively. This resulted in an increase of \$7 million and \$10 million in our allowance for loan losses for the six months ended June 30, 2010 and 2009, respectively.

Credit deterioration in the loan portfolio has been most notable in certain states and more recent loan vintages. Loans originated in California, Florida, Georgia, and Arizona accounted for a disproportionately large share (52%) of seriously delinquent loans held by consolidated Sequoia entities at June 30, 2010.

### **Market Valuation Adjustments at Other Consolidated Entities**

We apply the fair value option provided under GAAP for the assets (loans, securities, and unamortized deferred ABS issuance costs) and liabilities (ABS issued) of our consolidated Acacia securitization entities. This option requires that changes in the fair value of these assets, liabilities, and commitments be recorded in the consolidated statements of income (loss) each reporting period. Derivative assets and liabilities at Acacia securitization entities are accounted for as trading derivatives with all changes in the fair value of these assets

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and liabilities recorded through our consolidated statements of income (loss). There were a net negative \$1 million and negative \$9 million of market valuation adjustments on these assets and liabilities recognized through our consolidated statements of income (loss) for the three and six months ended June 30, 2010, respectively. At the Fund, there was \$1 million of negative market valuation adjustments on AFS securities recognized through our consolidated statements of income (loss) for both the three and six months ended June 30, 2010, all of which were deemed to be OTTI related to credit factors. At consolidated Sequoia entities, there were \$1 million of negative market valuation adjustments on real estate owned (REO) properties recognized through our consolidated statements of income (loss) for both the three and six months ended June 30, 2010.

### **Potential GAAP Earnings Volatility**

We expect quarter-to-quarter GAAP earnings volatility from our business activities. This volatility can occur for a variety of reasons, including the timing and amount of purchases, sales, calls, and repayment of consolidated assets, changes in the fair values of consolidated assets and liabilities, and certain non-recurring events. In addition, the amount or timing of our reported earnings may be impacted by technical accounting issues, some of which are described below.

### **Changes in Premium Amortization for Loans**

The unamortized premium for loans owned by Sequoia was \$46 million at June 30, 2010. The amount of periodic premium amortization expense we recognize is volatile and dependent on a number of factors, including credit performance of the underlying loans, changes in prepayment speeds, and changes in short-term interest rates. Loan premium amortization was \$4 million in the first six months of 2010, compared to \$11 million in the first six months of 2009.

### **Changes in Yields for Securities**

The yields we project on real estate securities can have a significant effect on the periodic interest income we recognize for financial reporting purposes. Yields can vary as a function of credit results, prepayment rates, and interest rates. If estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected for assets acquired at a discount to face value), the yield over the remaining life of the security may be adjusted upwards. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected for assets acquired at a discount to face value), the yield over the remaining life of the security may be adjusted downward.

Changes in the actual maturities of real estate securities may also affect their yields to maturity. Actual maturities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of AFS securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than ten years. There is no assurance that our assumptions used to estimate future cash flows or the current period's yield for each asset will not change in the near term, and any change could be material.

### **Changes in Fair Values of Securities**

All securities owned at Redwood and consolidated entities are classified as either trading or AFS securities, and in both cases are carried on our consolidated balance sheets at their estimated fair values. For trading securities, changes in fair values are recorded in the consolidated statements of income (loss). Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant GAAP earnings volatility each quarter.

For AFS securities, cumulative unrealized gains and losses are recorded as a component of accumulated other comprehensive income (loss) in our consolidated statements of equity. Unrealized gains and losses are not charged against current earnings to the extent they are temporary in nature. Certain factors may require us, however, to recognize these amounts as other-than-temporary impairments and record them through our current earnings. Factors that determine other-than-temporary-impairment include a change in our ability or intent to hold assets, adverse changes to projected cash flows of assets, or the likelihood that declines in the

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fair values of assets would not return to their previous levels within a reasonable time. Impairments can lead to significant GAAP earnings volatility each quarter.

**Changes in Fair Values of Derivative Financial Instruments**

We can experience significant earnings volatility from our use of derivatives. We generally use derivatives to hedge cash flows on assets and liabilities that have different coupon rates (fixed rates versus floating rates, or floating rates based on different indices). The nature of the instruments we use and the accounting treatment for the specific assets, liabilities, and derivatives may lead to volatile periodic earnings, even when we are meeting our hedging objectives.

Some of our derivatives are accounted for as trading instruments and their changes in market values flow through our consolidated statements of income (loss). The assets and liabilities we hedge may not be similarly accounted for as our hedging derivatives (e.g., they may be reported at cost, or only other-than-temporary impairments may be reported through our consolidated statements of income (loss)). This could lead to reported income and book values in specific periods that do not necessarily reflect the economics of our hedging strategy. Even when the assets and liabilities are similarly accounted for as trading instruments, periodic changes in their value may not coincide as other market factors (e.g., supply and demand) may affect certain instruments and not others at any given time.

**Results of Operations Estimated Taxable Income (Loss)**

The following table summarizes our estimated taxable income (loss) and distributions to shareholders for the three and six months ended June 30, 2010 and 2009. At both June 30, 2010 and 2009, we had no undistributed REIT taxable income.

**Table 19 Estimated Taxable Income (Loss) and Distributions to Shareholders**

| (In Thousands, Except per Share Data) | Three Months Ended<br>June 30, |              | Six Months Ended June 30, |              |
|---------------------------------------|--------------------------------|--------------|---------------------------|--------------|
|                                       | 2010                           | 2009         | 2010                      | 2009         |
| REIT taxable income (loss)            | \$ 2,883                       | \$ (10,379 ) | \$ 12,714                 | \$ (19,080 ) |
| Taxable REIT subsidiary loss          | (5,433 )                       | (1,662 )     | (14,116 )                 | (6,508 )     |
| Total Estimated Taxable Income (Loss) | \$ (2,550 )                    | \$ (12,041 ) | \$ (1,402 )               | \$ (25,588 ) |
| Distributed to shareholders           | \$ 19,498                      | \$ 19,382    | \$ 38,973                 | \$ 34,469    |

Our estimated total taxable loss for the second quarter of 2010 was \$3 million (\$0.03 per share) and included \$24 million in credit losses. This compared to an estimated total taxable loss for the second quarter of 2009 of \$12 million (\$0.16 per share), which included \$50 million of credit losses. We continue to expect credit losses to be the primary factor in 2010 and result in a taxable loss for the year.

For the three months ended June 30, 2010, we paid a regular quarterly dividend of \$0.25 per share. We currently expect that credit losses realized in 2010 will exceed our taxable income and, therefore, we anticipate that this year's dividend distributions will be characterized as return of capital. Dividends characterized as return of capital are not taxable and reduce the basis of shares held at each quarterly distribution date. However, if credit losses realized during the second half of 2010 are below our current expectations, and we do generate positive REIT taxable income in 2010, a portion of our dividend distributions will be characterized as ordinary income. This portion, if any, will be based upon the amount of REIT taxable income we generate in 2010 prior to the application of any REIT tax loss carry-forwards from prior periods that may ultimately reduce our reported REIT taxable income in 2010 to zero.

## **Differences between Taxable Income (Loss) and GAAP Income (Loss)**

Differences between taxable income and GAAP income are largely due to the following: (i) we cannot establish loss reserves for future anticipated events for tax but can for GAAP as realized credit losses are expensed when incurred for tax and these losses are anticipated through lower yields on assets or through loss provisions for GAAP; (ii) the timing, and possibly the amount, of some expenses (e.g., compensation expenses) are different for tax than for GAAP; (iii) since amortization and impairments differ for tax and GAAP, the tax and GAAP gains and losses on sales may differ, resulting in differences in realized gains on

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sale; for tax, we net capital gains on sales against any available capital losses; and, (iv) for tax, we do not consolidate noncontrolling interests or securitization entities as we do under GAAP. As a result of these differences in accounting, our taxable income can vary significantly from our GAAP income during certain reporting periods.

The tables below reconcile our tax and GAAP income (loss) for the three and six months ended June 30, 2010 and 2009.

### Table 20 Differences between Estimated Taxable (Loss) Income and GAAP Net Income (Loss)

| (In Thousands, Except per Share Data)                    | Three Months Ended June 30, 2010 |           |              |
|--|----------------------------------|-----------|--------------|
|  | Tax                              | GAAP      | Differences  |
| Interest income  | \$ 33,828                        | \$ 56,570 | \$ (22,742 ) |
| Interest expense   | (2,382 )                         | (21,164 ) | 18,782       |
| Net interest income                                      | 31,446                           | 35,406    | (3,960 )     |
| Provision for loan losses                                |                                  | (4,321 )  | 4,321        |
| Realized credit losses                                   | (24,427 )                        |           | (24,427 )    |
| Market valuation adjustments, net                        |                                  | (7,125 )  | 7,125        |
| Operating expenses                                       | (9,569 )                         | (11,227 ) | 1,658        |
| Realized gains, net                                      |                                  | 16,080    | (16,080 )    |
| Provision for income taxes                               |                                  | (26 )     | 26           |
| Less: Net income attributable to noncontrolling interest |                                  | 186       | (186 )       |
| Net (Loss) Income  | \$ (2,550 )                      | \$ 28,601 | \$ (31,151 ) |
| Estimated (loss) income per share                        | \$ (0.03 )                       | \$ 0.35   | \$ (0.38 )   |

| (In Thousands, Except per Share Data)                    | Three Months Ended June 30, 2009 |           |              |
|--|----------------------------------|-----------|--------------|
|  | Tax                              | GAAP      | Differences  |
| Interest income  | \$ 49,247                        | \$ 74,261 | \$ (25,014 ) |
| Interest expense   | (1,288 )                         | (39,001 ) | 37,713       |
| Net interest income                                      | 47,959                           | 35,260    | 12,699       |
| Provision for loan losses                                |                                  | (14,545 ) | 14,545       |
| Realized credit losses                                   | (50,142 )                        |           | (50,142 )    |
| Market valuation adjustments, net                        |                                  | (29,135 ) | 29,135       |
| Operating expenses                                       | (9,858 )                         | (10,769 ) | 911          |
| Realized gains, net                                      |                                  | 25,525    | (25,525 )    |
| Benefit from income taxes                                |                                  | 514       | (514 )       |
| Less: Net income attributable to noncontrolling interest |                                  | 127       | (127 )       |
| Net (Loss) Income  | \$ (12,041 )                     | \$ 6,723  | \$ (18,764 ) |
| Estimated (loss) income per share                        | \$ (0.16 )                       | \$ 0.10   | \$ (0.26 )   |

| (In Thousands, Except per Share Data) | Six Months Ended June 30, 2010 |            |              |
|---------------------------------------|--------------------------------|------------|--------------|
|                                       | Tax                            | GAAP       | Differences  |
| Interest income                       | \$ 71,505                      | \$ 115,288 | \$ (43,783 ) |
| Interest expense                      | (3,457 )                       | (39,346 )  | 35,889       |

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|  |             |           |              |
|--|-------------|-----------|--------------|
| Net Interest Income                                      | 68,048      | 75,942    | (7,894 )     |
| Provision for loan losses                                |             | (13,797 ) | 13,797       |
| Realized credit losses                                   | (48,677 )   |           | (48,677 )    |
| Market valuation adjustments, net                        |             | (18,362 ) | 18,362       |
| Operating expenses                                       | (20,773 )   | (28,533 ) | 7,760        |
| Realized gains, net                                      |             | 60,417    | (60,417 )    |
| Provision for income taxes                               |             | (52 )     | 52           |
| Less: Net income attributable to noncontrolling interest |             | 171       | (171 )       |
| Net (Loss) Income  | \$ (1,402 ) | \$ 75,444 | \$ (76,846 ) |
| Estimated (loss) income per share                        | \$ (0.02 )  | \$ 0.94   | \$ (0.96 )   |

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| (In Thousands, Except per Share Data)                  | Six Months Ended June 30, 2009 |              |              |
|--|--------------------------------|--------------|--------------|
|  | Tax                            | GAAP         | Differences  |
| Interest income  | \$ 99,730                      | \$ 155,698   | \$ (55,968 ) |
| Interest expense                                       | (2,618 )                       | (86,642 )    | 84,024       |
| Net Interest Income                                    | 97,112                         | 69,056       | 28,056       |
| Provision for loan losses                              |                                | (30,577 )    | 30,577       |
| Realized credit losses                                 | (102,755 )                     |              | (102,755 )   |
| Market valuation adjustments, net                      |                                | (72,379 )    | 72,379       |
| Operating expenses                                     | (19,945 )                      | (21,308 )    | 1,363        |
| Realized gains, net                                    |                                | 25,988       | (25,988 )    |
| Benefit from income taxes                              |                                | 409          | (409 )       |
| Less: Net loss attributable to noncontrolling interest |                                | (589 )       | 589          |
| Net (Loss) Income                                      | \$ (25,588 )                   | \$ (28,222 ) | \$ 2,634     |
| Estimated (loss) income per share                      | \$ (0.38 )                     | \$ (0.48 )   | \$ 0.10      |

**Potential Taxable Income Volatility**

We expect quarter-to-quarter estimated taxable income volatility for a variety of reasons, including those described below.

**Credit Losses on Securities and Loans at Redwood**

To determine estimated taxable income we are generally not permitted to anticipate, or reserve for, credit losses on investments which are generally purchased at a discount. For tax purposes, we accrue the entire purchase discount on a security into taxable income over the expected life of the security. Estimated taxable income is reduced when actual credit losses occur. For GAAP purposes, we establish a credit reserve and only accrete a portion of the purchase discount, if any, into income and write-down securities that become impaired. Our income recognition is therefore faster for tax as compared to GAAP, especially in the early years of owning a security (when there are generally few credit losses). At June 30, 2010, the cumulative difference between the GAAP and tax amortized costs basis of our residential, commercial, and CDO subordinate securities (excluding our investments in the Fund and our securitization entities) was \$233 million.

As we have no credit reserves or allowances for tax, any future credit losses on securities or loans will have a more significant impact on tax earnings than on GAAP earnings and may create significant taxable income volatility to the extent the level of credit losses fluctuates during reporting periods. During the three and six months ended June 30, 2010, we realized \$24 million and \$49 million, respectively, of credit losses on securities for tax that we had previously provisioned for under GAAP. We anticipate that tax losses will continue to be a significant factor in 2010. Credit losses are based on our tax basis, which differs materially from our basis for GAAP purposes. We anticipate an additional \$197 million of tax losses on securities, based on our projection of face losses and assuming a similar tax basis as we have recently experienced, although the quarterly timing of actual losses is difficult to accurately project. As of June 30, 2010, for GAAP we had a designated credit reserve of \$544 million on our securities and an allowance for loan losses of \$61 million for our consolidated residential and commercial loans.

**Recognition of Gains and Losses on Sale**

Since amortization and impairments on assets differ for GAAP and tax, the GAAP and tax basis on assets sold may differ, resulting in differences in gains and losses on sale. Thus, although we sold assets in the second quarter of 2010



and realized a gain for GAAP purposes of \$16 million, for tax purposes these sales generated gains of \$9 million and were used to offset prior capital losses. The majority of this difference relates to the timing variances in the recognition of income and losses. In addition, gains realized for tax may be offset by prior capital losses and, thus, not affect taxable income. As of June 30, 2010, the REIT had \$81 million in capital loss carry-forwards (\$1.04 per share) that can be used to offset future capital gains over the next five years. Since our intention is to generally invest in assets for the long-term, it is difficult to anticipate when sales may occur and, thus, when or whether we might exhaust these capital loss carry-forwards.

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**Prepayments on Securities**

As part of our investment in Sequoia securitization entities, we have retained interest-only (IOs) securities at the time they are issued. Our current tax basis in these securities is \$21 million. The return on IOs is sensitive to prepayments, and, to the extent prepayments vary quarter over quarter, income from these IOs will vary. Typically, fast prepayments reduce yields and slow prepayments increase yields. We are not permitted to recognize a negative yield under tax accounting rules, so during periods of fast prepayments our periodic premium expense for tax purposes can be relatively low and the tax cost basis for these securities may not be significantly reduced. In periods prior to 2008, we did experience fast prepayments on these loans. More recently, prepayments have been slowing, and our tax basis is now below the fair values for these IOs. Most of our Sequoia securitizations are callable or will become callable over the next two years, although we do not currently anticipate calling any Sequoia securitizations in the foreseeable future. If we do call a Sequoia securitization, the remaining tax basis in the IO is written off, creating an ordinary loss at the call date.

Prepayments also affect the quarterly recognition on other securities we own. We are required to use particular prepayment assumptions for the remaining lives of each security. As actual prepayment speeds vary, the yield we recognize for tax purposes in a quarter will be adjusted accordingly. Thus, to the extent prepayments differ from our long-term assumptions or vary from quarter to quarter, the yield recognized will also vary and this difference could be material for a specific security.

**Compensation Expense**

The total tax expense for equity award compensation is dependent upon varying factors such as the timing of payments of dividend equivalent rights, the exercise of stock options, the distribution of deferred stock units, and the cash deferrals to and withdrawals from our Executive Deferred Compensation Plan. For GAAP, the total expense associated with an equity award is determined at the award date and is recognized over the vesting period. For tax, the total expense is recognized at the date of distribution or exercise, not the award date. In addition, some compensation may not be deductible for tax if it exceeds certain levels and is not performance-based. Thus, the total amount of compensation expense, as well as the timing, could be significantly different for tax than for GAAP. In addition, since the decision to exercise options or distribute DSUs or cash out of the Executive Deferred Compensation Plan is an employee's, it can be difficult to project when the tax expense will occur. Should there be significant differences in quarterly activity in this regard, our taxable income could be volatile.

TABLE OF CONTENTS**Financial Condition**

The majority of the assets shown on our consolidated balance sheets are owned by our consolidated entities. The earning assets of these entities represent 81% of our consolidated earning assets and the liabilities (ABS issued) of these entities represent 96% of our consolidated liabilities. Although we consolidate these assets and liabilities for financial reporting purposes, they are bankruptcy-remote from us. That is, they are structured so that our liabilities are not liabilities of the securitization entities and the ABS issued by the securitization entities are not obligations of ours.

The following table shows the components of our balance sheet at June 30, 2010.

**Table 21 Consolidating Balance Sheet**

| June 30, 2010<br>(In Millions)               | Redwood<br>Parent | 2010<br>Sequoia | Other<br>Consolidated<br>Entities | Intercompany<br>Adjustments | Redwood<br>Consolidated |
|--|-------------------|-----------------|-----------------------------------|-----------------------------|-------------------------|
| Real estate loans                            | \$ 3              | \$ 226          | \$ 3,581                          | \$                          | \$ 3,810                |
| Real estate securities, at fair value:       |                   |                 |                                   |                             |                         |
| Trading securities                           | 18                |                 | 258                               |                             | 276                     |
| Available-for-sale securities                | 716               |                 | 52                                | (27 )                       | 741                     |
| Other investments                            |                   |                 | 4                                 |                             | 4                       |
| Cash and cash equivalents                    | 288               |                 |                                   |                             | 288                     |
| Investment in the 2010 Sequoia               | 28                |                 |                                   | (28 )                       |                         |
| Investment in Other Consolidated<br>Entities | 91                |                 |                                   | (91 )                       |                         |
| Total earning assets                         | 1,144             | 226             | 3,895                             | (146 )                      | 5,119                   |
| Other assets                                 | 41                | 3               | 56                                |                             | 100                     |
| Total Assets                                 | \$ 1,185          | \$ 229          | \$ 3,951                          | \$ (146 )                   | \$ 5,219                |
| Short-term debt                              | \$                | \$              | \$                                | \$                          | \$                      |
| Other liabilities                            | 54                | 1               | 87                                |                             | 142                     |
| Asset-backed securities issued               |                   | 200             | 3,761                             | (27 )                       | 3,934                   |
| Long-term debt                               | 140               |                 |                                   |                             | 140                     |
| Total liabilities                            | 194               | 201             | 3,848                             | (27 )                       | 4,216                   |
| Stockholders' equity                         | 991               | 28              | 91                                | (119 )                      | 991                     |
| Noncontrolling interest                      |                   |                 | 12                                |                             | 12                      |
| Total equity                                 | 991               | 28              | 103                               | (119 )                      | 1,003                   |
| Total Liabilities and Equity                 | \$ 1,185          | \$ 229          | \$ 3,951                          | \$ (146 )                   | \$ 5,219                |

**Analysis of Earning Assets****Real Estate Loans**

On April 28, 2010 we consolidated \$238 million of residential loans in our 2010 Sequoia securitization SEMT 2010-H1. All of the loans securitized are prime-quality, first-lien loans made to borrowers with demonstrated credit histories. Additionally, all of the loans are hybrid loans originated in 2009. The weighted average FICO score for these loans outstanding was 768 and the weighted average original loan-to-value ratio (LTV) was 57% at origination.

During the second quarter of 2010, there were \$12 million in principal repayments on the 2010 Sequoia

securitizations.

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The following table provides details of residential real estate loans activity at the Sequoia securitization entities during the three and six months ended June 30, 2010.

### Table 22 Residential Real Estate Loans at Sequoias Issued Prior to 2010 Activity

| (In Millions)                  | Three Months<br>Ended June<br>30,<br>2010 | Six Months<br>Ended June 30,<br>2010 |
|--------------------------------|---|--------------------------------------|
| Balance at beginning of period | \$ 3,643                                  | \$ 3,725                             |
| Principal repayments           | (71 )                                     | (139 )                               |
| Charge-offs, net               | 4   | 7                                    |
| Transfers to REO               | (8 )                                      | (13 )                                |
| Premium amortization           | (2 )                                      | (4 )                                 |
| Provision for credit losses    | (4 )                                      | (14 )                                |
| Balance at End of Period       | \$ 3,562                                  | \$ 3,562                             |

The majority of the loans at the Sequoia securitizations issued prior to 2010 are prime-quality, seasoned residential loans made to borrowers with demonstrated credit histories. Approximately \$3.52 billion (or 98%) of outstanding loan balances held at Sequoia securitization entities represents first-lien loans collateralized by residential properties. The remaining \$58 million are second-lien loans also collateralized by residential properties. As of June 30, 2010, \$3.30 billion of Sequoia loans (92% of outstanding principal balances) were originated in 2005 or prior and have many years of demonstrated payment histories. The weighted average FICO score for our Sequoia loans outstanding was 733 and the weighted average original loan-to-value ratio (LTV) was 66%. At June 30, 2010, 96% of residential loans (by unpaid principal balance) held at Sequoia securitization entities were one-month or six-month ARMs and 4% were hybrid loans.

### Loan Characteristics for All Sequoia Entities

Of the \$380 million of hybrid loans held at Sequoia securitization entities at June 30, 2010, \$73 million (or 19%) had reset as of June 30, 2010, and are now floating rate loans. The following table highlights the scheduled reset dates for outstanding hybrid loans held at all Sequoia entities that have not reached their first reset as of June 30, 2010.

### Table 23 Held-for-Investment Hybrid Loan Reset Dates

| (In Millions) | June 30,<br>2010 |
|---------------|------------------|
| Reset Date    |                  |
| 2010          | \$ 1             |
| 2011          |                  |
| 2012          | 41               |
| 2013          | 2                |
| 2014          | 244              |
| 2015          | 3                |
| 2017          | 16               |

Total Outstanding Principal

\$ 307

Prepayment speeds on loans held at all Sequoia entities remain low as one- and six-month LIBOR rates have remained low relative to historical averages. As of June 30, 2010, LIBOR ARM loans at Sequoia had a weighted average coupon of 1.70% and hybrid loans had a weighted average coupon of 4.47%.

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The following chart details the prepayment speeds of loans held at Sequoia securitization entities over the past four years.

**Residential Loans at Sequoia Entities  
Prepayment Speeds**

**Allowance for Loan Losses at All Sequoia Entities**

Each quarter we perform a process in accordance with GAAP to provide management with a reasonable and adequate estimate of loan loss reserving needs. This methodology is disclosed in *Note 3* to the financial statements included in

Part I Item 1 of this Quarterly Report on Form 10-Q. Our analysis is also discussed both in *Note 7* to the financial statements as well as in this Management's Discussion and Analysis of Financial Condition and Results of Operations under the sub-heading Results of Operations - Other Consolidated Entities .

**Real Estate Securities at Redwood Parent**

The following table provides real estate securities activity at Redwood for the three and six months ended June 30, 2010.

**Table 24 Real Estate Securities Activity at Redwood Parent**

**Three Months Ended June 30, 2010**

| (In Millions)                | Residential |          |             |            | Commercial | Total  |
|------------------------------|-------------|----------|-------------|------------|------------|--------|
|                              | Senior      | Re-REMIC | Subordinate | Commercial |            |        |
| Beginning fair value         | \$ 740      | \$ 67    | \$ 23       | \$ 9       | \$ 1       | \$ 840 |
| Acquisitions                 | 17          |          | 6           |            |            | 23     |
| Sales proceeds               | (111 )      | (5 )     |             |            |            | (116 ) |
| Gains on sales, net          | 13          | 3        |             |            |            | 16     |
| Effect of principal payments | (26 )       |          | (1 )        |            |            | (27 )  |
| Change in fair value, net    | (3 )        | 4        | (2 )        | (1 )       |            | (2 )   |
| Ending Fair Value            | \$ 630      | \$ 69    | \$ 26       | \$ 8       | \$ 1       | \$ 734 |

**Six Months Ended June 30, 2010**

| (In Millions)                | Residential |          |             |            | Commercial | Total  |
|------------------------------|-------------|----------|-------------|------------|------------|--------|
|                              | Senior      | Re-REMIC | Subordinate | Commercial |            |        |
| Beginning fair value         | \$ 644      | \$ 106   | \$ 21       | \$ 9       | \$ 1       | \$ 781 |
| Acquisitions                 | 191         |          | 12          |            |            | 203    |
| Sales proceeds               | (184 )      | (56 )    |             |            |            | (240 ) |
| Gains on sales, net          | 28          | 26       |             |            |            | 54     |
| Effect of principal payments | (47 )       |          | (2 )        |            |            | (49 )  |
| Change in fair value, net    | (2 )        | (7 )     | (5 )        | (1 )       |            | (15 )  |
| Ending Fair Value            | \$ 630      | \$ 69    | \$ 26       | \$ 8       | \$ 1       | \$ 734 |





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

The following table presents the carrying value (which equals fair value) as a percent of face value for securities owned at Redwood at June 30, 2010 and December 31, 2009.

**Table 25 Fair Value as Percent of Principal Value for Real Estate Securities at Redwood Parent**

| June 30, 2010<br>(Dollars in Millions)     | 2004 & Earlier |      | 2005   |      | 2006   | 2008 | Total  |      |
|--|----------------|------|--------|------|--------|------|--------|------|
|  | Value          | %    | Value  | %    |        |      | Value  | %    |
| Residential Senior                         |                |      |        |      |        |      |        |      |
| Prime                                      | \$ 14          | 83 % | \$ 227 | 84 % | \$ 69  | 82 % | \$ 310 | 83 % |
| Non-prime                                  | 114            | 83 % | 197    | 79 % | 9      | 71 % | 320    | 80 % |
| Total                                      | 128            | 83 % | 424    | 81 % | 78     | 81 % | 630    | 82 % |
| Residential Re-REMIC                       | 5              | 49 % | 9      | 49 % | 55     | 50 % | 69     | 50 % |
| Residential Subordinate                    |                |      |        |      |        |      |        |      |
| Prime                                      | 12             | 8 %  | 3      | 5 %  | 1      | 1 %  | 16     | 5 %  |
| Non-prime                                  | 9              | 38 % | 1      | 10 % |        |      | 10     | 22 % |
| Total                                      | 21             | 11 % | 4      | 6 %  | 1      | 1 %  | 26     | 8 %  |
| Commercial                                 | 7              | 16 % | 1      | 1 %  |        |      | 8      | 5 %  |
| CDO  |                |      | 1      | 6 %  |        |      | 1      | 6 %  |
| Total Securities at Redwood                | \$ 161         |      | \$ 439 |      | \$ 134 |      | \$ 734 |      |
| December 31, 2009<br>(Dollars in Millions) |                |      |        |      |        |      |        |      |
| Residential Senior                         |                |      |        |      |        |      |        |      |
| Prime                                      | \$ 14          | 81 % | \$ 248 | 81 % | \$ 67  | 76 % | \$ 329 | 80 % |
| Non-prime                                  | 118            | 81 % | 183    | 72 % | 14     | 43 % | 315    | 73 % |
| Total                                      | 132            | 81 % | 431    | 77 % | 81     | 67 % | 644    | 76 % |
| Residential Re-REMIC                       | 4              | 41 % | 13     | 41 % | 89     | 42 % | 106    | 41 % |
| Residential Subordinate                    |                |      |        |      |        |      |        |      |
| Prime                                      | 15             | 8 %  | 3      | 5 %  | 2      | 2 %  | 20     | 6 %  |
| Non-prime                                  |                |      | 1      | 11 % |        |      | 1      | 11 % |
| Total                                      | 15             | 8 %  | 4      | 5 %  | 2      | 2 %  | 21     | 5 %  |
| Commercial                                 | 7              | 16 % | 2      | 1 %  |        |      | 9      | 6 %  |
| CDO  |                |      | 1      | 7 %  |        |      | 1      | 7 %  |
| Total Securities at Redwood                | \$ 158         |      | \$ 451 |      | \$ 172 |      | \$ 781 |      |

## **Residential Securities at Redwood Parent**

Prime residential securities are residential mortgage-backed securities backed by prime loans. Many of these loans are jumbo loans, with loan balances greater than existing GSE conforming loan limits. Prime securities typically have relatively high weighted average FICO scores (700 or higher), low weighted average loan-to-value ratios (75% LTV or less), and limited concentrations of investor properties. Regardless of whether or not the loans backing a mortgage-backed security are of prime quality, there is still a risk that the borrower may not be able to repay the loan.

Non-prime securities are residential mortgage-backed securities that are generally backed by non-prime loans. Most of the borrowers backing non-prime loans have lower FICO scores or impaired credit histories, but exhibit the ability to repay the loan. To compensate for the greater risks and higher costs to service

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non-prime loans, borrowers often pay higher interest rates, and possibly higher origination fees. We use loss assumptions that are significantly higher when acquiring securities backed by non-prime loans than we use when acquiring securities backed by prime loans, all else equal.

The following table presents the components of carrying value at June 30, 2010 and December 31, 2009, for our residential securities.

**Table 26 Carrying Value of Residential Securities at Redwood Parent**

| June 30, 2010<br>(In Millions)                 | Residential |           |
|--|-------------|-----------|
|  | Prime       | Non-prime |
| Current face of AFS securities                 | \$ 808      | \$ 432    |
| Credit reserve                                 | (288 )      | (27 )     |
| Net unamortized discount                       | (185 )      | (117 )    |
| Amortized cost                                 | 335         | 288       |
| Gross unrealized gains                         | 82          | 27        |
| Gross unrealized losses                        | (22 )       | (2 )      |
| Carrying value of AFS securities               | 395         | 313       |
| Carrying value of trading securities           |             | 17        |
| Total Carrying Value of Residential Securities | \$ 395      | \$ 330    |

| December 31, 2009<br>(In Millions)             | Residential |           |
|--|-------------|-----------|
|  | Prime       | Non-prime |
| Current face of AFS securities                 | \$ 1,016    | \$ 496    |
| Credit reserve                                 | (375 )      | (84 )     |
| Net unamortized discount                       | (248 )      | (135 )    |
| Amortized cost                                 | 393         | 277       |
| Gross unrealized gains                         | 90          | 41        |
| Gross unrealized losses                        | (29 )       | (8 )      |
| Carrying value of AFS securities               | 454         | 310       |
| Carrying value of trading securities           | 1           | 6         |
| Total Carrying Value of Residential Securities | \$ 455      | \$ 316    |

The following table details the carrying value of residential securities at Redwood by the product type and collateral vintage at June 30, 2010 and December 31, 2009. At June 30, 2010, the securities we held consisted of fixed-rate assets (38%), adjustable-rate assets that reset within the next year (42%), hybrid assets that reset between 12 and 36 months (5%), and hybrid assets that reset after 36 months (15%).

**Table 27 Carrying Value of Residential Securities at Redwood Parent By Product and Vintage**

| June 30, 2010<br>(In Millions)<br>Prime | Vintage           |      |      |      | Total |
|---|-------------------|------|------|------|-------|
|   | 2004 &<br>Earlier | 2005 | 2006 | 2008 |       |

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|                              |        |        |        |        |
|------------------------------|--------|--------|--------|--------|
| ARM                          | \$ 3   | \$     | \$     | \$ 3   |
| Hybrid                       | 22     | 229    | 94     | 345    |
| Fixed                        | 6      | 10     | 31     | 47     |
| Total prime                  | 31     | 239    | 125    | 395    |
| Non-prime                    |        |        |        |        |
| Option ARM                   |        | 13     |        | 13     |
| ARM                          | 5      |        |        | 5      |
| Hybrid                       | 98     | 21     |        | 119    |
| Fixed                        | 21     | 163    | 9      | 193    |
| Total non-prime              | 124    | 197    | 9      | 330    |
| Total Residential Securities | \$ 155 | \$ 436 | \$ 134 | \$ 725 |

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| December 31, 2009<br>(In Millions) | Vintage<br>2004 &<br>Earlier | 2005   | 2006   | 2008 | Total  |
|------------------------------------|------------------------------|--------|--------|------|--------|
| Prime                              |                              |        |        |      |        |
| ARM                                | \$ 1                         | \$     | \$     |      | \$ 1   |
| Hybrid                             | 25                           | 261    | 121    |      | 407    |
| Fixed                              | 6                            | 4      | 37     |      | 47     |
| Total prime                        | 32                           | 265    | 158    |      | 455    |
| Non-prime                          |                              |        |        |      |        |
| Option ARM                         |                              | 21     | 6      |      | 27     |
| ARM                                | 2                            |        |        |      | 2      |
| Hybrid                             | 105                          | 56     |        |      | 161    |
| Fixed                              | 11                           | 107    | 8      |      | 126    |
| Total non-prime                    | 118                          | 184    | 14     |      | 316    |
| Total Residential Securities       | \$ 150                       | \$ 449 | \$ 172 |      | \$ 771 |

The loans underlying all of our residential subordinate securities totaled \$55 billion at June 30, 2010, consisting of \$51 billion prime and \$4 billion non-prime. These loans are located nationwide with a large concentration in California (46%). During the second quarter of 2010, realized losses on our residential subordinate securities reduced our credit reserve by \$57 million. Serious delinquencies (90+ days, in foreclosure or REO) at June 30, 2010 were 8.02% of current balances. Serious delinquencies were 6.33% of current balances for loans in prime pools and 27.75% of current balances for loans in non-prime pools.

Some of the underlying factors impacting the performance of our residential securities include housing prices and loan modifications. We believe overall housing prices may be approaching the bottom of this housing cycle, but we expect further price declines in certain markets. We note that home price depreciation since 2006 has been sufficient to generally restore nation-wide housing affordability to levels consistent with long-term stability. Price-to-rent and price-to-income metrics are within their historic range, which suggests that the fundamentally driven reversion in home prices is nearing an end for the nation as a whole, but not necessarily in each market. However, oversupply continues to be the major obstacle to a recovery in home prices. Even in markets where affordability has been restored, supply overhang is holding prices down. This is the primary reason for our belief that housing prices have further to decline in certain markets.

## Commercial Securities at Redwood Parent

We invest in commercial securities, a type of mortgage-backed security that is secured by one or more loans on commercial properties. We have not acquired any commercial securities in two years, though we may acquire commercial securities in the future if pricing for these securities becomes attractive to us relative to the risks taken.

Currently, all of our existing commercial investments at Redwood are subordinate securities predominantly issued in 2004 and 2005. The fair value of these securities totaled \$8 million and \$9 million at June 30, 2010 and December 31, 2009, respectively. These securities provided credit enhancement on \$24 billion of underlying loans on office, retail, multifamily, industrial, and other income-producing properties nationwide. Seriously delinquent loans (60+ days delinquent, in foreclosure or REO) underlying commercial subordinate securities were \$1.3 billion at June 30, 2010, an increase of \$540 million from December 31, 2009. Our credit reserve of \$128 million at June 30, 2010, reflects our expectation that we will only receive a small amount of principal over the remaining life of these securities, as credit losses in excess of our investments in each securitization will be borne by other investors senior to us. Since we

generally do not anticipate prepayments on our commercial securities, our expected returns are therefore based on our receipt of interest on the outstanding face value of the securities until credit losses are realized or our cash flow is otherwise halted by the trustee due to appraisal reductions on the collateral underlying loans in special servicing or for other reasons related to the anticipation of an economic loss. Realized credit losses on our commercial securities were \$12 million during the second quarter of 2010 and were charged against our designated credit reserve.

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The following table provides information on the activity at the other consolidated entities for the three and six months ended June 30, 2010.

**Table 28 Securities at Other Consolidated Entities Activity**

| Three Months Ended June 30, 2010<br>(In Millions) | Residential |             |            |       | Total  |
|---|-------------|-------------|------------|-------|--------|
|   | Senior      | Subordinate | Commercial | CDO   |        |
| Beginning fair value                              | \$ 124      | \$ 100      | \$ 55      | \$ 17 | \$ 296 |
| Sales proceeds                                    |             | (1 )        |            |       | (1 )   |
| Gains on sales, net                               |             |             |            |       |        |
| Effect of principal payments                      | (3 )        | (3 )        | (1 )       | (2 )  | (9 )   |
| Change in fair value, net                         |             | 1           | (4 )       |       | (3 )   |
| Ending Fair Value                                 | \$ 121      | \$ 97       | \$ 50      | \$ 15 | \$ 283 |

  

| Six Months Ended June 30, 2010<br>(In Millions) | Residential |             |            |       | Total  |
|---|-------------|-------------|------------|-------|--------|
|   | Senior      | Subordinate | Commercial | CDO   |        |
| Beginning fair value                            | \$ 132      | \$ 102      | \$ 55      | \$ 18 | \$ 307 |
| Sales proceeds                                  | (13 )       | (1 )        |            |       | (14 )  |
| Gains on sales, net                             | (1 )        |             |            |       | (1 )   |
| Effect of principal payments                    | (5 )        | (7 )        | (1 )       | (2 )  | (15 )  |
| Change in fair value, net                       | 8           | 3           | (4 )       | (1 )  | 6      |
| Ending Fair Value                               | \$ 121      | \$ 97       | \$ 50      | \$ 15 | \$ 283 |

The fair value of securities held at the Fund was \$25 million at June 30, 2010, which includes \$10 million of unrealized losses. We recognized \$1 million of other-than-temporary impairments on these securities in the second quarter of 2010. In addition to the \$258 million of real estate securities included in the table above, consolidated Acacia securitization entities owned \$27 million of ABS issued by Sequoia securitization entities, \$4 million in non-real estate securities, and \$19 million in commercial loans at June 30, 2010.

**Derivative Financial Instruments at Acacia Securitization Entities**

At June 30, 2010, consolidated Acacia securitization entities were party to interest rate agreements with an aggregate notional value of \$1.5 billion and an aggregate fair value of net negative \$73 million. Derivative obligations of Acacia entities are payable solely from the assets of those Acacia entities and are not obligations of Redwood. These derivatives are accounted for as trading instruments with all changes in value and any net payments and receipts recognized through market valuation adjustments, net, in our consolidated statements of income (loss).

At June 30, 2010, one Acacia entity held a credit default swap (CDS) with a \$4 million notional balance and a fair value of negative \$4 million. At December 31, 2009, one Acacia entity held CDS with a notional balance of \$20 million and a fair value of negative \$20 million. During the three and six months ended June 30, 2010, the reference securities underlying these CDS experienced principal losses resulting in a \$7 million and \$17 million obligation, respectively. The increase in fair value, net of principal losses, on CDS is recognized through market valuation adjustments, net, in our consolidated statements of income (loss).





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The following table presents our contractual obligations and commitments as of June 30, 2010, as well as the obligations of the securitization entities that we sponsor and consolidate for financial reporting purposes.

**Table 29 Contractual Obligations and Commitments as of June 30, 2010**

| (In Millions)   | Payments Due or Commitment Expiration by Period |                  |               |               |                 |
|---|---|------------------|---------------|---------------|-----------------|
|   | Total   | Less Than 1 Year | 1 to 3 Years  | 3 to 5 Years  | After 5 Years   |
| <b>Obligations of Redwood</b>                         |   |                  |               |               |                 |
| Short-term debt                                       | \$  | \$               | \$            | \$            | \$              |
| Long-term debt  | 140   |                  |               |               | 140             |
| Anticipated interest payments on long-term debt       | 254   | 4                | 12            | 17            | 221             |
| Accrued interest payable                              | 1   | 1                |               |               |                 |
| Operating leases                                      | 12  | 2                | 4             | 2             | 4               |
| Purchase commitments                                  |   |                  |               |               |                 |
| <b>Total Redwood Obligations and Commitments</b>      | <b>\$ 407</b>                                   | <b>\$ 7</b>      | <b>\$ 16</b>  | <b>\$ 19</b>  | <b>\$ 365</b>   |
| <b>Obligations of Securitization Entities</b>         |   |                  |               |               |                 |
| Consolidated ABS <sup>(1)</sup>                       | \$ 6,654  | \$               | \$            | \$            | \$ 6,654        |
| Anticipated interest payments on ABS <sup>(2)</sup>   | 3,240   | 66               | 223           | 357           | 2,594           |
| Accrued interest payable                              | 6   | 6                |               |               |                 |
| <b>Total obligations of Securitization Entities</b>   | <b>\$ 9,900</b>                                 | <b>\$ 72</b>     | <b>\$ 223</b> | <b>\$ 357</b> | <b>\$ 9,248</b> |
| <b>Total Consolidated Obligations and Commitments</b> | <b>\$ 10,307</b>                                | <b>\$ 79</b>     | <b>\$ 239</b> | <b>\$ 376</b> | <b>\$ 9,613</b> |

(1) All consolidated ABS issued are collateralized by real estate loans and securities. Although the stated maturity is as shown, the ABS obligations will pay down as the principal of these real estate loans or securities pay down. The amount shown is the face value of the ABS issued and not necessarily the value reported in our consolidated financial statements.

(2) The anticipated interest payments on consolidated ABS issued is calculated based on the contractual maturity of the ABS and therefore assumes no prepayments of the principal outstanding as of June 30, 2010.

**Redwood s Obligations**

In 2006, we issued \$100 million of long-term debt in the form of trust preferred securities through Redwood Capital Trust I, a wholly-owned Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than January 30, 2037. The earliest optional redemption date without a penalty is January 30, 2012. In 2007, we issued \$50 million of long-term debt in the form of subordinated notes, which require quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed, no later than July 30, 2037. The earliest optional redemption date without penalty is July 30, 2012. In July 2008 we repurchased \$10 million principal amount of this subordinated debt in the open market at a cost of \$3.4 million. We may from time to time seek to purchase outstanding long-term debt in open market purchases, privately negotiated transactions, or otherwise. Any future repurchases would depend on numerous factors including, without limitation, pricing, market conditions, and our capital requirements.

To hedge the variability in our long-term debt interest expense, we entered into interest rate swaps with aggregate notional values totaling \$140 million during the first quarter of 2010, fixing our gross interest expense yield at 6.75%. These swaps are accounted for as cash flow hedges with all interest income recorded as a component of net interest income and other valuation changes recorded as a component of equity through the life of the hedge.

TABLE OF CONTENTS**All Consolidated Entities Obligations**

At June 30, 2010, there were \$3.8 billion of loans owned by Sequoia securitization entities and reported at cost, which were funded with \$3.7 billion of ABS issued by Sequoia entities that were also reported at cost. To date, credit losses have not yet been incurred on any of the senior securities issued by Sequoia securitization entities, although some of these senior securities may incur losses in the future, depending on the magnitude and timing of additional credit losses incurred on the underlying loans. In April 2010, Redwood securitized \$238 million of loans through our Sequoia program, with approximately \$211 million of ABS issued to third parties. At June 30, 2010, there were \$258 million of securities owned by Acacia securitization entities and reported at fair value, which were funded with \$253 million of ABS issued by Acacia entities that were also reported at fair value.

The following table provides detail on the activity for asset-backed securities issued by all of our consolidated entities for the three and six months ended June 30, 2010.

**Table 30 ABS Issued Activity Securitization Entities**

| (In Thousands)                               | Three Months Ended June 30, 2010 |              |             |                        |              |                      | June 30, 2010 |
|--|----------------------------------|--------------|-------------|------------------------|--------------|----------------------|---------------|
|  | March 31, 2010                   | New Issuance | Paydowns    | Extinguishment of Debt | Amortization | Valuation Adjustment |               |
| Sequoia ABS issued with principal value, net | \$3,539,653                      | \$211,178    | \$(85,885)  | \$(276)                | \$(196)      | \$                   | \$3,664,474   |
| Sequoia ABS interest only issued             | 18,016                           |              |             |                        | (868)        |                      | 17,148        |
| Total Sequoia ABS issued                     | 3,557,669                        | 211,178      | (85,885)    | (276)                  | (1,064)      |                      | 3,681,622     |
| Acacia ABS issued                            | 279,471                          |              | (17,761)    |                        |              | (8,606)              | 253,104       |
| Total ABS Issued                             | \$3,837,140                      | \$211,178    | \$(103,646) | \$(276)                | \$(1,064)    | \$(8,606)            | \$3,934,726   |

**Stockholders Equity**

The following table provides a summary of changes to stockholders equity for the three and six months ended June 30, 2010.

**Table 31 Stockholders Equity**

| (In Millions)  | Three Months Ended June 30, 2010 | Six Months Ended June 30, 2010 |
|--|----------------------------------|--------------------------------|
| Balance at beginning of period                       | \$ 998                           | \$ 972                         |
| Issuance of new equity capital, net                  | 3                                | 11                             |
| Unrealized losses on securities and derivatives, net | (19)                             | (27)                           |
| Distributions to shareholders                        | (20)                             | (40)                           |
| Net income attributable to Redwood Trust, Inc.       | 29                               | 75                             |

|                          |        |        |
|--------------------------|--------|--------|
| Balance at End of Period | \$ 991 | \$ 991 |
|--------------------------|--------|--------|

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The following table provides cumulative balances of unrealized gains and losses by the type of investment at June 30, 2010 and December 31, 2009.

**Table 32 Cumulative Other Comprehensive Income (Loss)**

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## **Critical Accounting Policies**

See the *Critical Accounting Policies* section in *Management's Discussion and Analysis of Financial Condition and Results of Operations*, as well as *Note 3* to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2009, for a detailed discussion of the Company's critical accounting policies. Since the issuance of our Annual Report on Form 10-K for the year ended December 31, 2009, any changes to our critical accounting policies or the methodologies or assumptions we apply under them are noted in *Note 3* to the consolidated financial statements presented in this Quarterly Report on Form 10-Q. We also describe in *Note 3* certain recent accounting pronouncements that will amend the critical accounting policies we apply in future periods.

## **Market Risks**

We seek to manage the risks inherent in our business—including but not limited to credit risk, interest rate risk, prepayment risk, liquidity risk, and fair value risk—in a prudent manner designed to enhance our earnings and dividends and preserve our capital. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, and to maintain capital levels consistent with these risks.

## **Credit Risk**

Integral to our core business is assuming the credit risk of real estate loans primarily through the ownership of residential and commercial real estate loans and securities. Some of our capital base is employed in owning credit enhancement securities that have below investment-grade credit ratings due to their concentrated credit risks with respect to underlying real estate loans and investment-grade securities. We believe that many of the loans underlying these securities are above-average in credit quality as compared to U.S. real estate loans in general (although there may nevertheless be significant credit losses in respect to these loans), but the balance and percentage of loans with special risk factors (higher risk commercial loans, interest-only and negative amortization residential loan types, and Alt-A and subprime residential loans) has increased and continues to increase. We may also own residential real estate loans that are not securitized.

Credit losses from the loans in securitized loan pools, in general, first reduce the principal value of and economic returns on the lower-rated securities in these pools. Credit losses on real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; decline in the value of homes, businesses, or commercial properties; special hazards; earthquakes and other natural events; over-leveraging of the borrower or on the property; reduction in market rents and occupancies and poor property management practices; changes in legal protections for lenders; reduction in personal incomes; job loss; and personal events such as divorce or health problems. In addition, if the U.S. economy or the housing market weakens further than we have anticipated, our credit losses could increase beyond levels that we have anticipated. Credit losses on real estate loans can vary for reasons not related to the general economy.

With respect to most of the loans securitized by securitization entities sponsored by us and for a portion of the loans underlying residential loan securities we have acquired from securitizations sponsored by others, the interest rate is adjustable. Accordingly, when short-term interest rates rise, required monthly payments from homeowners may rise under the terms of these loans, and this may increase borrowers' delinquencies and defaults.

We also own securities backed by negative amortization adjustable-rate loans made to residential borrowers, some of

which are prime-quality loans while many are Alt-A quality loans (and a few are subprime loans). We invest in these riskier loan types with the expectation of significantly higher delinquencies and losses as compared to regular amortization loans, but believe these securities offer us the opportunity to generate attractive risk-adjusted returns as a result of attractive pricing and the manner in which these securitizations are structured. Nevertheless, there remains substantial uncertainty about the future performance of these assets.

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The large majority of the commercial loans we credit-enhance are fixed-rate loans, some of which are interest-only loans. In general, these loans are not fully amortizing and therefore require balloon payments at maturity. Consequently, we could be exposed to credit losses at the maturity of these loans if the borrower is unable to repay or refinance the borrowing with another third party lender.

We will experience credit losses on residential and commercial loans and securities, and to the extent the losses are consistent with the amount and timing of our assumptions, we expect to earn attractive returns on our investments. We manage our credit risks by understanding the extent of the risk we are taking and insuring the appropriate underwriting criteria are met, and we utilize systems and staff to continually monitor the ongoing credit performance of each loan and security. To the extent we find the credit risks on specific assets are changing adversely, we may be able to take actions (which may include selling the assets) to mitigate potential losses. However, we may not always be successful in foreseeing adverse changes in credit performance or in effectively mitigating future credit losses and the ability to sell an asset may be limited due to the structure of the asset or the absence of a liquid market for the asset.

In addition to residential and commercial subordinate securities, Redwood, the Fund, and Acacia own senior and other securities issued by securitization entities that are sponsored by others. A risk we face with respect to these securities is that we do not generally control or influence the underwriting, servicing, management, or loss mitigation with respect to these underlying loans.

The Acacia entities, the Fund, and Redwood also own securities backed by subprime and Alt-A residential loans that have substantially higher credit risk characteristics than prime-quality loans. Consequently, we can expect these lower-quality loans to have higher rates of delinquency and loss, and if such losses differ from our assumptions, Acacia, the Fund, and Redwood could suffer losses.

The Acacia entities also own certain senior securities and subordinate securities purchased from the Sequoia securitization entities we sponsor. If the pools of residential and commercial loans underlying these securities were to experience poor credit results, these securities could suffer decreases in fair value, or could experience principal losses. If any of these events occurs, it would likely reduce our returns from these investments.

## **Interest Rate Risk**

Interest rates and the shape of the yield curve can affect the cash flows and fair values of our assets, liabilities, and interest rate agreements, and consequently, affect our earnings and reported equity. Our general strategy with respect to interest rates is to maintain an asset/liability posture (including hedges) on a consolidated basis that assumes some interest rate risks but not to such a degree that the achievement of our long-term goals would likely be affected by changes in interest rates. Accordingly, we are willing to accept short-term volatility of earnings and changes in our reported equity in order to accomplish our goal of achieving attractive long-term returns.

To implement our interest rate risk strategy, we may use interest rate agreements in an effort to maintain a close match between pledged assets and debt, as well as between the interest rate characteristics of the assets in the securitization entities and the corresponding ABS issued. However, we generally do not attempt to completely hedge changes in interest rates, and at times, we may be subject to more interest rate risk than we generally desire in the long term. Changes in interest rates will have an impact on the values and cash flows of our assets and corresponding liabilities.



## Prepayment Risk

We seek to maintain an asset/liability posture that benefits from investments in prepayment-sensitive assets while limiting the risk of adverse prepayment fluctuations to an amount that, in most circumstances, can be absorbed by our capital base while still allowing us to make regular dividend payments.

Prepayments affect GAAP earnings in the near-term primarily through the timing of the amortization of purchase premium and discount and through triggering market valuation adjustments. For example, amortization income from discount assets may not necessarily offset amortization expense from premium assets, and vice-versa. In addition, variations in current and projected prepayment rates for individual assets and changes in interest rates (as they affect projected coupons on ARMs and other assets and thus change

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effective yield calculations) may cause net premium amortization expense or net discount amortization income to vary substantially from quarter to quarter. Moreover, the timing of premium amortization on assets may not always match the timing of the premium amortization on liabilities even when the underlying assets and liabilities are in the same securitization and pay down at the same rate.

Prepayment risks exist in the assets and associated liabilities consolidated on our balance sheets. In general, discount securities benefit from faster prepayment rates on the underlying real estate loans while premium securities (such as IOs) benefit from slower prepayments on the underlying loans. We are currently biased in favor of faster prepayment speeds with respect to the long-term economic effect of residential loan prepayments. We note that changes in residential loan prepayment rates could result in GAAP and tax earnings volatility.

With respect to securities backed by residential mortgage loans (and in particular, IOs), changes in prepayment forecasts by market participants could affect the market values of those securities sold by securitization entities, and thus could affect the economics associated with securitizing assets.

Our credit results and risks can also be affected by prepayments. For example, credit risks for the securities we own are reduced each time a loan prepays. All other factors being equal, faster prepayment rates reduce our credit risks on our existing portfolio.

We caution that prepayment rates are difficult to predict or anticipate, and variations in prepayment rates can materially affect our earnings and dividend distribution requirements. ARM prepayment rates, for example, are driven by many factors, one of which is the steepness of the yield curve. As the yield curve flattens (short-term interest rates rise relative to longer-term interest rates), ARM prepayments typically increase. However, for borrowers who have impaired credit or who otherwise do not meet loan underwriting criteria, the ability to refinance (i.e., prepay) a loan even when interest rates decline may be limited.

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## **Fair Value and Liquidity Risks**

The securities that we sponsor are generally funded with equity with no associated recourse debt that might affect our liquidity position. The assets and liabilities at Acacia are accounted for under the fair value option, with all changes in market values being recorded through our income statement. Though this potentially creates earnings volatility, the securities and ABS issued by Acacia entities have no recourse to us that would otherwise affect our liquidity position.

Most of the real estate loans that we consolidate are accounted for using the held-for-investment GAAP classification and are reported at their amortized cost. Most of these loans have been sold to Sequoia entities and, thus, changes in the fair value of the loans do not have an impact on our liquidity. However, changes in fair values during the accumulation period (while these loans are funded with short-term debt before they are sold to a Sequoia entity) may have a short-term effect on our liquidity. We may also own some real estate loans accounted for as held-for-sale and adverse changes in their value would be recognized through our income statement and may have an impact on our ability to obtain financing for them.

Our consolidated obligations consist primarily of ABS issued. Changes in fair value of ABS issued have no impact on our liquidity. ABS issued by Sequoia are reported at amortized cost as are the residential loans collateralizing these ABS. We report at fair value the ABS issued by Acacia and also report the underlying securities collateralizing the ABS issued at fair value. In either case, the resulting net equity (assets less liabilities) may not necessarily be reflective of the fair value of our interests in these securitization entities. However, since the ABS issued can only look to the cash flows generated by the assets within that securitization for payments of interest and repayments of the face value of the ABS, the changes in fair value do not have an effect on Redwood's liquidity. Only to the extent that changes in fair values affect the timing of the cash flows we might receive on our investments in the Acacia entities is there an effect to Redwood from changes in fair values of these securities.

We may fund some assets with a combination of short-term debt and equity (generally prior to securitization) that is recourse to Redwood. This generally increases our fair value and liquidity risks. We manage these risks by maintaining what we believe to be conservative capital levels under our internal risk-adjusted capital and risk management policies and by ensuring we have a variety of financing facilities available to fund each of our assets. We also manage risk by hedging the loans held for securitization to minimize the fluctuations in value prior to securitization.

## **Inflation Risk**

Virtually all of our consolidated assets and liabilities are financial in nature. As a result, changes in interest rates and other factors drive our performance far more than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates.

Our financial statements are prepared in accordance with GAAP. Our activities and balance sheets are measured with reference to historical cost or fair value without considering inflation.

## **Effect of Government Initiatives on Market Risks**

Recent market and economic conditions have been unprecedented and challenging. There are continuing concerns about the overall economy, the systemic impact of inflation or deflation, energy costs, geopolitical issues, the availability and cost of credit, the U.S. mortgage market, unemployment, and the declining real estate market in the U.S.

These market and economic conditions have spurred government initiatives and interventions designed to address them. Given the size and scope of the government actions, they will affect many of the market risks described above, although the total impact is not yet fully known. As these initiatives are further developed and their effects become more apparent, we will continue to seek to take them into account in managing the risks inherent in our business.

### **Dodd-Frank Wall Street Reform and Consumer Protection Act**

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Reform Act ). The Reform Act will result in, among other things, significant revisions to the legal and regulatory framework within which financial services firms and financial market participants

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operate. The Reform Act will directly impact Redwood as a result of changes to laws and regulations that Redwood is subject to and that govern financial markets in which Redwood participates. In addition, the Reform Act will also affect Redwood as a result of its impact on the business and regulation of many of Redwood's current and potential counterparties, service providers, and competitors, as well as its impact on entities that currently, or may in the future, invest in mortgage-backed securities that are issued through our Sequoia securitization platform.

We believe that certain aspects of the Reform Act may, in fact, have a positive impact on Redwood, while other aspects could negatively impact our future business and results of operations. The Reform Act is over 2,300 pages long, contains numerous provisions that require the adoption of new regulations by various federal agencies, and will require interpretation by regulators and courts in order to clarify many of its provisions. In addition, there may be unintended consequences of the Reform Act and Congress may act in the future to amend or supplement aspects of the Reform Act. As a result, it is not possible at this time to fully understand the Reform Act's future impact on Redwood and our business. Please see the Risk Factors included in our Annual Report on Form 10-K for fiscal year ended

December 31, 2009, including, without limitation, the Risk Factor entitled *Federal and state legislative and regulatory developments, and the actions of governmental authorities and entities, may adversely affect our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future,* which is set forth on page 5 of that Annual Report.

Set forth in the paragraphs below are summaries of certain aspects of the Reform Act that are or may be directly applicable to us and our current and future business and operations. As noted above, it is difficult to fully appreciate at this time the manner in which the Reform Act may affect Redwood as a result of its future impact on various financial markets, housing markets, investors, counterparties, competitors, and service providers. Aspects of the Reform Act that are not discussed below could also have significant or material impacts (positive or negative) on our future business and operations. In addition, as described above under Recent Developments, the failure of the Reform Act to address (other than by requiring further study of the matter) the future of the government sponsored enterprises, Fannie Mae and Freddie Mac, means that the future role of the federal government in the mortgage finance markets remains unresolved, resulting in significant uncertainty as to the future role of the private sector, including Redwood, in those markets. We continue to believe that ultimately the role of the government and government sponsored enterprises in the mortgage finance markets will decrease, opening up more of this market for private sector companies like Redwood.

### **Securitization Reform**

The Reform Act includes substantial reforms to the laws governing the issuance of asset-backed securities and requires the adoption of federal regulations to implement these reforms. These reforms include risk retention requirements (or so-called "skin-in-the-game" requirements) that will apply to sponsors of securitization transactions, heightened disclosure obligations relating to the offering materials for, and ongoing reporting relating to, securitization transactions, and prohibitions on securitization sponsors engaging in transactions that result in material conflicts of interest with investors in securitization transactions.

Through our Sequoia securitization platform we are engaged in sponsoring securitizations of residential mortgage debt. In addition, our business includes investing in securitization transactions sponsored by third parties. As a general matter we believe that the Reform Act will help revive the market for private sector securitizations of residential mortgage debt, which would also increase the number of investment opportunities available to us. However, the Reform Act may also increase the cost of conducting our securitization business and will likely impose certain operating limitations on us as we proceed in engaging in this business.

It is difficult to predict with certainty how the Reform Act will affect the future of the securitization markets, in part due to the fact that federal agencies have not yet published proposals for the new regulations that are mandated by this legislation. Furthermore, other matters, such as the accounting standards applicable to securitized assets, capital and leverage requirements applicable to banks and other regulated financial institutions, and existing regulatory proposals relating to securitization transactions, also have the potential to significantly affect the future of the securitization markets.

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### **Rating Agency Reform**

Under the Reform Act there will be a new framework for regulating rating agencies and an Office of Credit Ratings is established within the SEC as the rating agencies' regulator. The Reform Act also exposes rating agencies to a greater degree of liability for their published ratings, including by giving investors the right in certain circumstances to sue rating agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.

The issuance of asset-backed securities, including the issuance of mortgage-backed securities through our Sequoia securitization platform, generally involves engaging one or more rating agencies to publish ratings of the securities issued. Changes to the regulation of rating agencies may affect our ability to obtain, and the cost of obtaining, ratings for securitization transactions conducted through our Sequoia platform and any inability to obtain ratings might render us unable to access this financing market or could render mortgage-backed securities issued through the Sequoia securitization platform ineligible investments for certain types of investors. For example, immediately following the passage of the Reform Act, the three major rating agencies, Moody's, S&P, and Fitch, suspended the issuance of new ratings for asset-backed securities while they studied the impact of the Reform Act on their exposure to liability. This suspension had the immediate impact of effectively closing the market for newly-issued publicly-registered asset-backed securities. Through the issuance of a no action letter, the SEC has allowed this market to resume functioning by temporarily not requiring ratings to be included in the prospectuses for newly issued asset-backed securities. This temporary solution is scheduled to expire in approximately six months. Since we plan to conduct future securitization transactions, any failure to resolve this issue could prevent us from executing future securitization transactions in accordance with our plans. In any case, the imposition of a greater degree of regulation and liability on rating agencies is likely to increase the cost and effort involved in obtaining ratings for the issuance of mortgage-backed securities through our Sequoia securitization platform. In addition, rating agencies may demand that we indemnify them for losses they could incur as a result of their increased exposure to liability for issuing ratings, which could increase our potential exposure to liability.

### **Mortgage Reform**

The Reform Act enhances the regulation of various aspects of the residential mortgage origination and servicing businesses, establishes independence requirements for appraisers, and establishes minimum national standards for determining that a borrower has a reasonable ability to repay a home loan at the time the loan is made. In addition, the Reform Act prescribes requirements for nonstandard loan products and prohibits certain origination practices that have been perceived as predatory.

While Redwood is not in the business of originating or servicing residential mortgages, we do acquire mortgages originated by others, securitize mortgages originated by others, and invest in mortgage credit through third-party securitizations and other instruments. As a result, reforms that affect mortgage origination are likely to have an indirect impact on Redwood. Like other aspects of the Reform Act, it is difficult to predict with certainty how the Reform Act will affect the future of the residential mortgage markets and mortgage origination. To the extent that reforms reduce risks to investors that are associated with an originator's underwriting of residential mortgage credit risk, the Reform Act could positively impact Redwood. On the other hand, reforms that increase the cost of originating mortgages or expose investors who acquire mortgage loans to additional potential liability for origination violations, could negatively impact Redwood.

### **Derivatives Reform**

Under the Reform Act, a new regulatory regime is established for over-the-counter (OTC) derivatives, including the mandated use (subject to certain exceptions) of exchanges and central clearinghouses for executing and settling OTC derivative transactions. In addition, the Reform Act gives federal regulators the authority to (i) impose capital and margin requirements on dealers and major participants in the OTC derivatives markets with respect to swaps that are not settled through central clearinghouses and (ii) ban abusive swaps if they believe such swaps would be detrimental to the stability of a financial market or participants in a financial market. The Reform Act also requires banks with federal deposit insurance to transfer certain OTC derivatives activity to separate non-bank affiliates.



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In the ordinary course of its business Redwood enters into derivatives transactions as a means of hedging or fixing interest rate costs and other financial exposures. In addition, from time to time Redwood may enter into other derivatives transactions, including as part of entering into a structured credit risk transfer. Reforms to the OTC derivatives markets that enhance stability, reduce risk, and increase transparency should be positive for market participants such as Redwood that are not generally engaged in these markets as a dealer. However, reforms that reduce our ability to utilize derivatives as a means of structuring credit risk transfers, or increase the costs of transacting in derivatives or the applicable margin requirements could increase our costs in engaging in these types of transactions.

### **Establishment of Bureau of Consumer Financial Protection**

The Reform Act establishes a Bureau of Consumer Financial Protection (CFPB) that will be housed within the Federal Reserve, but headed by a Director who is appointed by the President (subject to Senate confirmation). The CFPB will have authority over financial products and services offered by both banks and nonbanks to consumers, including mortgages. In addition to the potential effects on the mortgage market of the presence of this new regulatory agency, our business and operations may be directly or indirectly impacted by regulations promulgated by the CFPB because, among other things, we are a purchaser of residential mortgage loans, we may hold servicing rights with respect to residential mortgage loans, we hold consent rights with respect to certain actions taken by loan servicers with respect to residential mortgage loans, and we have access to personal information regarding residential mortgage borrowers.

## **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Information concerning market risk is incorporated herein by reference to Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2009, as supplemented by the information under Management's Discussion and Analysis of Financial Condition and Results of Operations Market Risks above. Other than developments described under Management's Discussion and Analysis of Financial Condition and Results of Operations above, including changes in the fair values of our assets, there have been no other material changes in our quantitative or qualitative exposure to market risk since December 31, 2009.

## **Item 4. Controls and Procedures**

We have adopted and maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed on our reports under the Securities Exchange Act of 1934, as amended (the Exchange Act) is recorded, processed, summarized, and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms and that the information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) of the Exchange Act, we have carried out an evaluation, under the supervision and with the participation of management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure

controls and procedures were effective at a reasonable assurance level.

There have been no changes in our internal control over financial reporting during the second quarter of 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II

### Item 1. Legal Proceedings

As described in Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2009, on December 23, 2009, the Federal Home Loan Bank of Seattle (the "FHLB Seattle") filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against us, our subsidiary, Sequoia Residential Funding, Inc., Morgan Stanley & Co., and Morgan Stanley Capital, Inc. (collectively, the "Defendants"). The FHLB Seattle alleges claims under the Securities Act of Washington, Section 21.20.005, *et seq.*, and seeks to rescind the purchase and sale of a mortgage pass-through certificate (or, Residential Mortgage Backed Security, "RMBS") issued through our Sequoia RMBS platform and purchased by FHLB Seattle. The FHLB Seattle seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys' fees and costs. On January 22, 2010, Defendants removed the suit to federal court in the Western District of Washington (case number 2:10-cv-00132-RSM). The FHLB Seattle moved to remand the case to state court on March 11, 2010. The District Court has not ruled on the motion to remand. On June 10, 2010, the FHLB Seattle filed an amended complaint in the District Court. The FHLB Seattle alleges that Defendants' offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the credit quality of the mortgage loans that backed it. Among other things, the FHLB Seattle alleges that Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of these properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS.

On July 12, 2010, we received two notices of Election to Void Sale of Securities pursuant to Illinois Securities Law, 815 ILCS Section 5/13(A), from the Federal Home Loan Bank of Chicago ("FHLB Chicago"). FHLB Chicago seeks to void its purchase of two RMBS that were issued in 2006 by a securitization trust with respect to which Sequoia Residential Funding, Inc. was the depositor. The notices were addressed to us, to two of our subsidiaries, RWT Holdings, Inc. and Sequoia Residential Funding, Inc., to the securitization trust which issued these two RMBS, Sequoia Mortgage Trust 2006-1, as well as to the underwriters of these RMBS and certain other unaffiliated third parties. The notices assert that the recipients of the notices and their controlling persons are jointly and severally liable for the full amount paid for these RMBS by the FHLB Chicago plus interest thereon at the rate stated in these RMBS, less the principal and interest amounts previously received.

Other than as disclosed in (i) the immediately preceding paragraphs, (ii) Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2009, and (iii) Note 14 "Commitments and Contingencies - Loss Contingencies - Litigation", which is included within the Notes to Consolidated Financial Statements set forth within Part I, Item 1 of this Quarterly Report on Form 10-Q, there are no material pending legal proceedings, or material changes with respect to pending legal proceedings, in each case, to which we or any of our subsidiaries is a party or of which our property is the subject.

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## Item 1A. Risk Factors

Our risk factors are discussed under Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2009. In addition, the following risk factor reflects recent developments.

**Our ability to execute future securitizations of residential mortgage loans could be delayed, limited, or precluded by legislative and regulatory reforms applicable to asset-backed securities and the institutions that sponsor, service, rate, or otherwise participate in, or contribute to, the successful execution of a securitization transaction. Other factors could also limit, delay, or preclude our ability to execute securitization transactions. These legislative, regulatory, and other factors could also reduce the returns we would otherwise expect to earn in connection with executing securitization transactions.**

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Reform Act). Provisions of the Reform Act will require, among other things, significant revisions to the legal and regulatory framework within which asset-backed securities (ABS), including residential mortgage-backed securities (RMBS), are issued through the execution of securitization transactions. In addition, prior to the passage of the Reform Act, the Securities and Exchange Commission (SEC) and the Federal Deposit Insurance Corporation (FDIC) had already published proposed regulations relating to the issuance of ABS, including RMBS. In addition to those described above, additional federal or state laws and regulations that could affect our ability to execute future securitization transactions could be proposed, enacted, or implemented.

It is difficult to predict with certainty how the Reform Act and the other regulations that have been proposed will affect our future ability to successfully execute securitizations of residential mortgage loans, due to, among other things, the fact that federal agencies have not yet published regulations implementing the Reform Act and the fact that it is not clear what effect the Reform Act will have on the proposed regulations that were previously published by the SEC and the FDIC. These laws and regulations could prevent us from executing securitization transactions, delay our execution of these types of transactions, or reduce the returns we would otherwise expect to earn from executing securitization transactions.

Immediately following the passage of the Reform Act, the three major credit rating agencies Moody's, S&P, and Fitch suspended the issuance of new ratings for ABS while they studied the impact of the Reform Act on their exposure to liability. This suspension had the immediate impact of effectively closing the market for newly-issued publicly-registered ABS. Through the subsequent issuance of a no action letter, the SEC has allowed this market to resume functioning by temporarily not requiring ratings to be included in the prospectuses for newly issued ABS. This temporary solution is scheduled to expire in approximately six months. Any failure to resolve this issue could prevent us from executing future securitization transactions in accordance with our plans because the issuance of ABS, including the issuance of RMBS through our Sequoia securitization program, generally involves engaging one or more rating agencies to publish ratings of the securities issued. Absent published ratings, investors may choose not to invest (or may be precluded from investing) in ABS or may only be willing to pay a lower price (or demand a higher yield) for ABS.

Rating agencies can affect our ability to execute a securitization transaction, or reduce the returns we would otherwise expect to earn from executing securitization transactions, not only by deciding not to publish ratings for our securitization transaction (or deciding not to consent to the inclusion of those ratings in the prospectuses we file with the SEC relating to securitization transactions), but also by altering the criteria and process they follow in publishing ratings. Rating agencies could alter their ratings processes or criteria after we have accumulated loans for securitization in a manner that effectively reduces the value of those previously acquired loans or requires that we incur additional costs to comply with those processes and criteria.

Furthermore, other matters, such as (i) accounting standards applicable to securitization transactions and (ii) capital and leverage requirements applicable to banks and other regulated financial institutions holdings of ABS, could result in less investor demand for securities issued through securitization transactions we execute or increased competition from other institutions that execute securitization transactions.

TABLE OF CONTENTS**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

During the three months ended June 30, 2010, we did not sell any equity securities that were not registered under the Securities Act of 1933, as amended. We announced a stock repurchase plan on November 5, 2007 for the repurchase of up to a total of 5,000,000 shares. This plan replaced all previous share repurchase plans and has no expiration date.

As of June 30, 2010, 4,658,071 shares remained available for repurchase under our stock repurchase plan.

The following table contains information on the shares of our common stock that we purchased during the six months ended June 30, 2010.

|                  |                  | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price per<br>Share Paid | Total Number<br>of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans<br>or Programs | Maximum<br>Number<br>of Shares that<br>May<br>Yet be Purchased<br>Under the Plans<br>or<br>Programs |
|------------------|------------------|---|------------------------------------|--|---|
| January 1, 2010  | January 31, 2010 | 4,923 <sup>(1)</sup>                      | \$ 14.46                           |  | 4,658,071   |
| February 1, 2010 | June 30, 2010    |   |                                    |  | 4,658,071   |
| Total            |                  | 4,923                                     | \$ 14.46                           |  | 4,658,071   |

<sup>(1)</sup> The 4,923 shares repurchased during January 2010 represent shares reacquired to satisfy tax withholding requirements on the vesting of restricted shares.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. (Removed and Reserved)****Item 5. Other Information**

None.

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**Item 6. Exhibits**

| Exhibit Number | Exhibit   |
|----------------|---|
| 3.1            | Articles of Amendment and Restatement of the Registrant, effective July 6, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1, filed on August 6, 2008)   |
| 3.1.1          | Articles Supplementary of the Registrant, effective August 10, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.1, filed on August 6, 2008)   |
| 3.1.2          | Articles Supplementary of the Registrant, effective August 11, 1995 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.2, filed on August 6, 2008)   |
| 3.1.3          | Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008)  |
| 3.1.4          | Certificate of Amendment of the Registrant, effective June 30, 1998 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.4, filed on August 6, 2008)   |
| 3.1.5          | Articles Supplementary of the Registrant, effective April 7, 2003 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.5, filed on August 6, 2008)   |
| 3.1.6          | Articles Supplementary of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008)   |
| 3.1.7          | Articles of Amendment effective May 19, 2009 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009)   |
| 3.2            | Amended and Restated Bylaws, as adopted on March 5, 2008 (incorporated by reference to Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008)   |
| 10.1*          | 2002 Redwood Trust, Inc. Incentive Plan, as amended on May 18, 2010 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 10.1, filed on May 19, 2010)   |
| 31.1           | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2           | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1           | Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2           | Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101**          | Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2010, is furnished in XBRL-formatted interactive data files: (i) Consolidated Statements of Income for the three and six months ended June 30, 2010 and 2009; (ii) Consolidated Balance Sheets at June 30, 2010 and December 31, 2009; (iii) Consolidated Statements of Changes in Equity and Comprehensive Income for the six months ended June 30, 2010 and 2009; (iv) Consolidated Statements of Cash Flows for the six months ended June 30, 2010 and 2009; and (v) Notes to Financial Statements. |

\* Indicates exhibits that include management contracts or compensatory plans or arrangements.

\*\* To be furnished in an amendment to this Form 10-Q to be filed within the time period permitted by Rule 405 of Regulation S-T.





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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**REDWOOD TRUST, INC.**

By:

Date: August 4, 2010

/s/ Martin S. Hughes  
Martin S. Hughes  
President and Chief Executive Officer  
(Principal Executive Officer)

By:

Date: August 4, 2010

/s/ Diane L. Merdian  
Diane L. Merdian  
Chief Financial Officer  
(Principal Financial Officer)

By:

Date: August 4, 2010

/s/ Christopher J. Abate  
Christopher J. Abate  
Controller  
(Principal Accounting Officer)

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