REDWOOD TRUST INC
Form 10-Q
November 03, 2011

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

FORM 10-Q

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

For the Quarterly Period Ended: September 30, 2011

OR

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

For the Transition Period from to .

Commission File Number 1-13759

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

Not Applicable

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

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

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

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

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

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

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

Common Stock, $0.01 par value per share	78,686,426 shares outstanding as of November 2, 2011

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2011 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data) (Unaudited)	September 30, 2011	December 31, 2010
ASSETS		
Residential real estate loans	$4,157,583	$3,797,095
Commercial real estate loans (includes $12,563 and $19,850 at fair value)	110,624	50,386
Real estate securities, at fair value:		
Trading securities	278,391	329,717
Available-for-sale securities	754,862	825,119
Total real estate securities	1,033,253	1,154,836
Other investments		
Cash and cash equivalents	133,446	46,937
Total earning assets	5,434,906	5,049,254
Restricted cash	17,011	24,524
Accrued interest receivable	14,699	13,782
Derivative assets	2,718	8,051
Deferred tax asset		3,487
Deferred securities issuance costs	8,819	5,928
Other assets	76,180	38,662
Total Assets[(1)]	$5,554,333	$5,143,688
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$	$44,137
Accrued interest payable	7,607	5,930
Derivative liabilities	127,220	83,115
Accrued expenses and other liabilities	8,413	14,305
Dividends payable	19,624	19,531
Asset-backed securities issued (includes $234,235 and $303,077 at fair value)	4,293,024	3,761,578
Long-term debt	139,500	139,500
Total liabilities[(2)]	4,595,388	4,068,096
Equity		
Common stock, par value $0.01 per share, 125,000,000 shares authorized; 78,494,886 and 78,124,668 issued and outstanding	785	781
Additional paid-in capital	1,695,642	1,689,851
Accumulated other comprehensive income	32,309	112,339

Cumulative earnings	503,841	474,940
Cumulative distributions to stockholders	(1,273,632)	(1,213,158)
Total stockholders equity	958,945	1,064,753
Noncontrolling interest		10,839
Total equity	958,945	1,075,592
Total Liabilities and Equity	$5,554,333	$5,143,688

(1) Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs. At September 30, 2011 and December 31, 2010, these assets totaled $4,592,312 and $3,941,212, respectively.

(2) Our consolidated balance sheets include liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At September 30, 2011 and December 31, 2010, these liabilities totaled $4,370,490 and $3,838,386, respectively.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data) (Unaudited)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest Income				
Residential real estate loans	$20,192	$17,514	$57,564	$47,749
Commercial real estate loans	2,353	323	5,379	895
Real estate securities	30,845	41,083	97,703	125,439
Other investments		2		14
Cash and cash equivalents	6	93	38	204
Total interest income	53,396	59,015	160,684	174,301
Interest Expense				
Short-term debt	(78)	(2)	(267)	(38)
Asset-backed securities issued	(21,855)	(21,074)	(62,526)	(57,127)
Long-term debt	(2,384)	(2,619)	(7,130)	(5,875)
Total interest expense	(24,317)	(23,695)	(69,923)	(63,040)
Net Interest Income	29,079	35,320	90,761	111,261
Provision for loan losses	(3,978)	(2,436)	(8,367)	(16,233)
Market valuation adjustments	(12,365)	1,007	(25,164)	(11,193)
Other-than-temporary impairments(1)	(1,083)	(2,580)	(5,171)	(8,742)
Market valuation adjustments, net	(13,448)	(1,573)	(30,335)	(19,935)
Net Interest Income After Provision and Market Valuation Adjustments	11,653	31,311	52,059	75,093
Operating expenses	(11,507)	(12,245)	(35,107)	(40,778)
Realized gains on sales and calls, net	1,145	1,566	10,844	61,985
Net income before provision for income taxes	1,291	20,632	27,796	96,300
Provision for income taxes	(14)	(202)	(42)	(254)
Net income	1,277	20,430	27,754	96,046
Less: Net (loss) income attributable to noncontrolling interest	(20)	532	(1,147)	703
Net Income Attributable to Redwood Trust, Inc.	$1,297	$19,898	$28,901	$95,343
Basic earnings per common share	$0.01	$0.25	$0.35	$1.19
Diluted earnings per common share	$0.01	$0.25	$0.35	$1.18
Regular dividends declared per common share	$0.25	$0.25	$0.75	$0.75
Basic weighted average shares outstanding	78,470,625	77,901,970	78,275,796	77,794,106
Diluted weighted average shares outstanding	78,470,625	78,961,205	78,275,796	78,763,689

(1) For the three months ended September 30, 2011, other-than-temporary impairments were $1,372, of which $289 thousand were recognized in Accumulated Other Comprehensive Income. For the three months ended September 30, 2010, other-than-temporary impairments were $6,287, of which

$3,707 were recognized in Accumulated Other Comprehensive Income.
For the nine months ended September 30, 2011, other-than-temporary impairments were $7,339, of which $2,168 were recognized in Accumulated Other Comprehensive Income. For the nine months ended September 30, 2010, other-than-temporary impairments were $16,988, of which $8,246 were recognized in Accumulated Other Comprehensive Income.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EQUITY AND COMPREHENSIVE INCOME

For the Nine Months Ended September 30, 2011

(In Thousands, Except Share Data) (Unaudited)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Noncontrolling Interest	Total
	Shares	Amount						
December 31, 2010	78,124,668	$781	$1,689,851	$112,339	$474,940	$(1,213,158)	$10,839	$1,075,592
Net income (loss)					28,901		(1,147)	27,754
Net unrealized (loss) gain on available-for-sale securities				(47,049)			4,164	(42,885)
Reclassification of other-than-temporary impairments to net income				3,306				3,306
Net unrealized loss on interest rate agreements				(39,498)				(39,498)
Reclassification of unrealized loss on interest rate agreements to net income				3,211				3,211
Total other comprehensive loss				(80,030)				
Total comprehensive loss								(48,112)
Issuance of common stock:								
Dividend reinvestment & stock purchase plans	310,146	3	4,580					4,583
Employee stock purchase and incentive plans	282,458	3	(2,857)					(2,854)
Non-cash equity award compensation			6,764					6,764
Share repurchases	(222,386)	(2)	(2,696)					(2,698)
Distributions to noncontrolling interest, net							(14,112)	(14,112)
Common dividends declared						(60,474)		(60,474)
Deconsolidation elimination							256	256
September 30, 2011	78,494,886	$785	$1,695,642	$32,309	$503,841	$(1,273,632)	$	$958,945

For the Nine Months Ended September 30, 2010

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands, Except Share Data) (Unaudited)	Nine Months Ended September 30,	
	2011	2010
Cash Flows From Operating Activities:		
Net income attributable to Redwood Trust, Inc.	$28,901	$95,343
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs, net	(24,618)	(25,508)
Depreciation and amortization of non-financial assets	768	624
Provision for loan losses	8,367	16,233
Non-cash equity award compensation	6,764	9,757
Market valuation adjustments, net	30,335	19,935
Realized gains on sales and calls, net	(10,844)	(61,985)
Net change in:		
Accrued interest receivable	(1,405)	3,967
Deferred tax asset	3,487	1,885
Other assets	(31,672)	(25,900)
Accrued interest payable	11,301	9,095
Accrued expenses and other liabilities	(5,892)	(56,398)
Net cash provided by (used in) operating activities	15,492	(12,952)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(724,950)	(300,211)
Principal payments on loans held-for-investment	282,126	260,493
Proceeds from sales of loans held-for-sale	1,857	
Purchases of available-for-sale securities	(90,512)	(235,876)
Proceeds from sales of available-for-sale securities	72,666	248,491
Principal payments on available-for-sale securities	86,734	104,987
Purchases of trading securities		(17,137)
Proceeds from sales of trading securities	13,588	6,119
Principal payments on trading securities	43,104	45,067
Principal payments on other investments		12,513
Net decrease in restricted cash	7,513	70,178
Net cash (used in) provided by investing activities	(307,874)	194,624
Cash Flows From Financing Activities:		
Net repayments on short-term debt	(44,137)	
Proceeds from issuance of asset-backed securities	884,771	211,178
Repurchase of asset-backed securities issued		(8,639)
Repayments on asset-backed securities issued	(350,246)	(330,864)
Deferred securities issuance costs	(4,598)	(1,667)
Net settlements of derivatives	(30,291)	(39,916)

Net proceeds from issuance of common stock	1,729	2,842
Net payments on repurchase of common stock	(2,696)	
Dividends paid	(60,382)	(59,865)
Change in noncontrolling interests	(15,259)	(8,296)
Net cash provided by (used in) financing activities	378,891	(235,227)
Net increase (decrease) in cash and cash equivalents	86,509	(53,555)
Cash and cash equivalents at beginning of period	46,937	242,818
Cash and cash equivalents at end of period	$133,446	$189,263
Supplemental Disclosures:		
Cash paid for interest	$55,809	$51,807
Cash paid for taxes	$48	$186
Dividends declared but not paid at end of period	$19,624	$19,496
Transfers from real estate loans to real estate owned	$8,418	$13,658

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 1. Redwood Trust

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

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

Note 2. Basis of Presentation

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

Organization

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

We sponsor two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the consolidated Sequoia securitization entities. Our Acacia program was used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia refer collectively to all the consolidated Acacia securitization entities. We also consolidate the assets and liabilities of the resecuritization we engaged in during the third quarter of 2011.

Principles of Consolidation

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

For financial reporting purposes, the underlying loans and securities owned at the Sequoia, Acacia, and resecuritization entities are shown on our consolidated balance sheets under real estate loans and real estate securities, and the asset-backed securities (ABS) issued to third-parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned by consolidated Sequoia, Acacia, and resecuritization entities and interest expense on the ABS issued by these entities. Prior to the third quarter of 2011, the real estate securities owned at the Fund were shown on our consolidated balance sheets under real estate securities and the portion of the Fund owned by third-parties was shown under noncontrolling interest. In our consolidated statements of income, we recorded interest income on the securities owned at the Fund.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 2. Basis of Presentation (continued)

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

Note 3. Summary of Significant Accounting Policies

Use of Estimates

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

Fair Value Measurements

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

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

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

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

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

Fair Value Option

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

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

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

Real Estate Loans

Residential and Commercial Real Estate Loans   Fair Value

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

Residential and Commercial Real Estate Loans   Held-for-Sale

Residential and commercial real estate loans held-for-sale include loans that we are marketing for sale to third-parties. These loans are carried at the lower of their cost or fair value, as measured on an individual basis. If the fair value of a loan held-for-sale is lower than its amortized cost basis, this difference is reported as a negative market valuation

adjustment through our consolidated statements of income. Coupon interest for loans held-for-sale is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Gains or losses on the sale of real estate loans are based on the specific identification method.

Residential and Commercial Real Estate Loans Held-for-Investment

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

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

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

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

Residential Real Estate Loans   Allowance for Loan Losses

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

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

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

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

As part of the loss mitigation efforts undertaken by servicers of residential loans owned by Sequoia securitization entities, a 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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

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 (TDR), it is removed from the general loan pools used for calculating allowances for loan losses and assessed for impairment on an individual basis based upon any adverse change in the expected future cash flows resulting from the modification. This difference is recorded to the provision for loan losses in our consolidated statements of income.

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

Repurchase Reserves

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

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

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

Commercial Real Estate Loans   Allowance for Loan Losses

For commercial real estate loans classified as held-for-investment, we evaluate the need for an allowance for loan losses on a quarterly basis. We will establish and maintain an allowance for loan losses for any loans we have determined to be impaired as of the reporting date.

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

Ongoing analysis of the most recent financial information for each loan and associated properties, including net operating income, debt service coverage ratios, occupancy rates, rent rolls, as well as any other loss factors we consider relevant, such as, but not limited to, specific loan trigger events that would indicate an adverse change in expected cash flows or payment delinquency;
Ongoing analysis of economic trends, both macroeconomic as well as those directly affecting the properties associated with our loans, and the supply and demand of competing projects in the sub-market in which the subject property is located; and,
Ongoing evaluation of each loan sponsor s ability to ensure that associated properties are managed and operated sufficiently.
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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

Based on the above review, a loan is impaired when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the loan. We record an allowance to reduce the carrying value of any impaired loan to the present value of expected future cash flows discounted at the loan s effective rate.

Such impairment analyses are completed and reviewed by asset management and finance personnel and reviewed and approved by senior management. Significant judgment is required when evaluating loans for impairment.

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

Real Estate Securities, at Fair Value

Trading Securities

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

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

Available-for-Sale (AFS) Securities

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

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

If we conclude through our analysis that there has been no significant adverse change in our cash flow assumptions for the security, then the impairment is deemed temporary in nature and the associated difference between the security s fair value and its amortized cost basis is recorded as an unrealized loss through accumulated other comprehensive income, a component of equity. Alternatively, if we conclude that there has been a significant adverse change in our cash flow assumptions for the security, then the impairment is

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

deemed an OTTI and we perform an additional analysis to determine what portion of OTTI, if any, should be recorded through our consolidated statements of income. This analysis entails discounting the security s cash flows to a present value using the prior period yield for the security to determine an expected recoverable value. The difference between this expected recoverable value and the amortized cost basis of the security is deemed to be the credit component of the OTTI that is recorded in our consolidated statements of income. The amortized cost of the security is then adjusted to the expected recoverable value, and the difference between this expected recoverable value and the fair value is deemed to be the non-credit component of the OTTI that is recorded to accumulated other comprehensive income. Future amortization and accretion for the security is computed based upon the new amortized cost basis.

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

Other Investments

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

Cash and Cash Equivalents

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

Restricted Cash

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

issued. At September 30, 2011, we did not have any significant concentrations of credit risk arising from restricted cash deposits as all of our restricted cash was held in custodial accounts or FDIC-insured bank products.

Accrued Interest Receivable

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

Derivative Financial Instruments

Derivative financial instruments include risk management derivatives namely interest rate agreements and credit derivatives. All derivative financial instruments are recorded at fair value in our consolidated balance sheets. Derivatives with a positive fair value to us are reported as an asset and derivatives with a negative fair value to us are reported as a liability. We classify each of our derivative

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

financial instruments as either (i) a trading instrument (no hedging designation) or (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

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

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

Risk Management Derivatives

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

Other risk management derivatives we currently utilize include To Be Announced (TBA) contracts and financial futures contracts such as Eurodollar futures and Treasury futures. (Eurodollar futures contracts, unlike our other

derivatives, have maturities of only three months. Therefore, in order to achieve the desired interest rate offset necessary to manage our risk, consecutively maturing contracts are required resulting in a stated notional amount higher than would be needed with our other derivatives.) TBA contracts are forward commitments to purchase U.S. government agency mortgage-backed securities to be issued in the future. Financial futures are futures contracts on short-term benchmark interest rates. We purchase or sell these hedging instruments to offset to varying degrees changes in the values of mortgage products for which we have exposure. We account for our risk management derivatives as trading instruments, and record any changes in value (including any associated interest income or expense) in our consolidated statements of income through market valuation adjustments, net.

Credit Derivatives

Credit derivatives that we have historically utilized include CDS, which are agreements to pay (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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

of a qualifying credit event (e.g., an interest shortfall, a failure to pay principal, or a distressed rating downgrade), the market perception of default risk and counterparty risk, and supply and demand changes. We do not designate any credit derivatives as cash flow hedges.

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

Deferred Tax Assets

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

Deferred Securities Issuance Costs

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

Other Assets

Other assets include REO, margin receivable, fixed assets, principal receivable, and other prepaid expenses. REO property acquired through, or in lieu of, loan foreclosure is initially recorded at fair value, and subsequently reported at the lower of carrying amount or fair value (less estimated cost to sell). Changes in the fair value of an REO property that has a fair value at or below its carrying amount are recorded in our consolidated statements of income as a component of market valuation adjustments, net. Margin receivable reflects cash collateral Redwood has posted with our various derivative and lending counterparties as required to satisfy the minimum margin requirements.

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

Short-Term Debt

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

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

Accrued Interest Payable

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

Asset-Backed Securities Issued

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

Sequoia ABS Issued

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

Acacia ABS Issued

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

Resecuritization ABS Issued

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

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

Long-Term Debt

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

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

Equity

Accumulated Other Comprehensive Income

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

Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership interests in the Fund held by third-parties. In accordance with GAAP, the noncontrolling interest of the Fund is shown as a component of equity on our consolidated balance sheets, and the portion of income allocable to third-parties is shown as net income (loss) attributable to noncontrolling interest in our consolidated statements of income. Equity attributable to noncontrolling interest is disclosed in our consolidated statements of equity and comprehensive income. As we deconsolidated the Fund in the third quarter of 2011, there is no longer noncontrolling interest.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

Earnings Per Common Share

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

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

See *Note 15* for further discussion on equity.

Incentive Plans

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

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

material to our financial statements.

Employee Stock Purchase Plan

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

Executive Deferred Compensation Plan

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

401(k) Plan

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

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

Taxes

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

See *Note 18* for further discussion on taxes.

Recent Accounting Pronouncements

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

debtor is facing financial difficulties. In addition, ASU 2011-02 ended the public-entity deferral of TDR disclosures in ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.*

We adopted ASU 2011-02 in the second quarter of 2011. At September 30, 2011, the recorded investment in receivables for which the allowance for loan losses was previously measured under a general allowance for loan losses and are now impaired under ASC 310-10-35 was $5 million, and the allowance for loan losses associated with those receivables, on a basis of current evaluation of loss, was $1 million at September 30, 2011. For additional disclosures related to TDRs, see *Note 6*.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 3. Summary of Significant Accounting Policies (continued)

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

Note 4. Principles of Consolidation

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

The tables below present our analysis of VIEs where we maintain an interest, as distinguished by those we have consolidated for financial reporting purposes and those we have not. The principles of consolidation we apply require us to reassess our requirement to consolidate VIEs each quarter and therefore our determination may change based upon new facts and circumstances pertaining to each VIE. This could result in a material impact to our financial statements during subsequent reporting periods.

Analysis of Consolidated VIEs

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

Assets and Liabilities of Consolidated VIEs at September 30, 2011

(Dollars in thousands)	Sequoia Entities	Acacia Entities	Resecuritization	Total
Real estate loans	$ 3,928,677	$ 12,563	$	$ 3,941,240
Real estate securities		256,192	349,764	605,956
Other investments				
Other assets	21,120	21,734	2,262	45,116
Total Assets	$ 3,949,797	$ 290,489	$ 352,026	$ 4,592,312
Asset-backed securities	$ 3,826,783	$ 234,235	$ 232,006	$ 4,293,024
Other liabilities	6,387	71,007	72	77,466
Total Liabilities	$ 3,833,170	$ 305,242	$ 232,078	$ 4,370,490
Noncontrolling interest	$	$	$	$
Number of VIEs	39	10	1	50

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. Since 2010, we have sponsored three residential jumbo mortgage securitizations through our Sequoia program

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 4. Principles of Consolidation (continued)

totaling $908 million. We recorded the assets and liabilities of these entities on our consolidated balance sheets, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Additionally, we determined that we are the primary beneficiary of these VIEs as our ongoing loss mitigation and resolution responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of these entities and our significant investment interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

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

We consolidate the assets and liabilities of the entity formed in connection with the resecuritization transaction we engaged in during the third quarter of 2011, as we did not meet the sale criteria at the time the financial assets were transferred to this entity and we are the primary beneficiary. We transferred an aggregate of $365 million ($437 million principal value) of residential senior securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold them to CSMC 2011-9R, a resecuritization entity. In connection with this transaction, senior securities of $245 million were issued by CSMC 2011-9R and sold to third-party investors and we acquired $192 million of subordinate securities issued by CSMC 2011-9R. We also received $243 million in cash and acquired $245 million notional amount of variable rate, interest-only senior certificates.

We engaged in the resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our residential securities portfolio. Our credit risk exposure is largely unchanged as a result of engaging in the transaction, as we remain economically exposed to the financed securities through the first loss position in the structure.

Prior to the third quarter of 2011, we consolidated the assets, liabilities, and noncontrolling interests of the Fund, as we determined that we were the primary beneficiary of this VIE. Our ongoing asset management responsibilities provided us with the power to direct the activities that most significantly impacted the Fund s economic performance, and our general and limited partnership interests provided us with the obligation to absorb losses or the right to receive benefits that were significant. In the second quarter of 2011, the Fund sold all of its remaining investments. As all partners received final cash asset distributions in the third quarter of 2011 and there are no remaining assets or liabilities in the Fund, we deconsolidated the Fund and recognized a loss on deconsolidation of less than $1 million in our consolidated statements of income through realized gains on sales and calls, net.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 4. Principles of Consolidation (continued)

Analysis of Third-party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interest in third-party VIEs at September 30, 2011, grouped by collateral type and ownership interest.

Third-Party VIE Summary

September 30, 2011 (Dollars in Thousands)	Fair Value	Number of VIEs
Real estate securities at Redwood		
Residential		
Senior	$ 226,078	62
Re-REMIC	113,100	13
Subordinate	81,222	173
Commercial	5,887	9
CDO	1,010	8
Total Third-party Real Estate Securities	$ 427,297	265

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

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

Note 5. Fair Value of Financial Instruments

For financial reporting purposes, we follow a fair value hierarchy established under GAAP that is used to measure the fair value of the assets and liabilities. This hierarchy prioritizes relevant market inputs in order to determine an exit

price , or the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale at the date of measurement. Level 1 inputs are observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs are observable inputs other than quoted prices for an asset or liability that are obtained through corroboration with observable market data. Level 3 inputs are unobservable inputs (e.g., our own data or assumptions) that are used when there is little, if any, relevant market activity for the asset or liability being measured at fair value.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at September 30, 2011 and December 31, 2010.

(In Thousands)	September 30, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential real estate loans (held-for-sale)	$2,178	$2,178	$1,855	$1,855
Residential real estate loans (held-for-investment)	4,155,405	3,693,867	3,795,240	3,367,340
Commercial real estate loans (fair value)	12,563	12,563	19,850	19,850
Commercial real estate loans (held-for-investment)	98,061	98,533	30,536	30,887
Trading securities	278,391	278,391	329,717	329,717
Available-for-sale securities	754,862	754,862	825,119	825,119
Cash and cash equivalents	133,446	133,446	46,937	46,937
Derivative assets	2,718	2,718	8,051	8,051
Restricted cash	17,011	17,011	24,524	24,524
Accrued interest receivable	14,699	14,699	13,782	13,782
REO (included in other assets)	6,554	6,554	14,481	14,481
Liabilities				
Short-term debt			44,137	44,137
Accrued interest payable	7,607	7,607	5,930	5,930
Derivative liabilities	127,220	127,220	83,115	83,115
ABS issued	4,293,024	3,711,728	3,761,578	3,263,074
Long-term debt	139,500	57,195	139,500	75,330

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

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

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

September 30, 2011	Carrying	Fair Value Measurements Using		
(In Thousands)	Value	Level 1	Level 2	Level 3
Assets				
Commercial real estate loans	$ 12,563	$	$	$ 12,563
Trading securities	278,391			278,391
Available-for-sale securities	754,862			754,862
Derivative assets	2,718	302	2,416	
Liabilities				
Derivative liabilities	127,220	2,465	104,755	20,000
ABS issued Acacia	234,235			234,235

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 5. Fair Value of Financial Instruments (continued)

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

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

(In Thousands)	Assets				Liabilities		
	Commercial Real Estate Loans	Trading Securities	AFS Securities	Derivative Assets	Derivative Liabilities	ABS Issued	Acacia
Beginning balance December 31, 2010	$19,850	$329,717	$825,119	$1	$	$303,077	
Transfer to Level 3					20,052		
Principal paydowns	(8,730)	(43,104)	(86,735)			(68,698)	
Gains (losses) in net income, net	1,443	4,962	28,991		1,651	(9,773)	
Losses in OCI, net			(39,581)				
Acquisitions			90,512				
Sales		(13,588)	(63,525)				
Other settlements, net		404	81	(1)	(1,703)	9,629	
Ending Balance September 30, 2011	$12,563	$278,391	$754,862	$	$20,000	$234,235	

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

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

Included in Net Income

(In Thousands)	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Assets				
Real estate loans	$ (184)	$ 3	$ 1,358	$ 7,347
Trading securities	(5,207)	46,819	(3,938)	64,531
Available-for-sale securities	(1,083)	(2,580)	(3,551)	(8,361)
Derivative assets		16		16
Liabilities				
Derivative liabilities	1,651	19	1,651	129
ABS issued Acacia	16,530	(25,703)	9,773	(19,699)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS September 30, 2011 (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 September 30, 2011.

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

(In Thousands)	Carrying Value	Fair Value Measurements Using			Gain (Loss)	
		Level 1	Level 2	Level 3	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Assets						
Real estate loans (held-for-sale)	$ 2,178	$	$	$ 2,178	$ 363	$ 374
REO	6,554			6,554	(255)	(1,416)

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

Market Valuation Adjustments, Net

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Assets				
Real estate loans (fair value)	$ (184)	$ 3	$ 1,358	$ 7,347
Real estate loans (held-for-sale)	363	159	374	335
Trading securities	(5,359)	47,375	4,963	65,854
REO	(255)	(620)	(1,416)	(1,979)
Impairments on AFS securities	(1,083)	(2,580)	(5,171)	(8,742)
Liabilities				
Derivative instruments, net	(23,460)	(20,207)	(40,216)	(63,051)
ABS issued Acacia	16,530	(25,703)	9,773	(19,699)

Market Valuation Adjustments, Net	$ (13,448)	$ (1,573)	$ (30,335)	$ (19,935)

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

Real estate loans

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

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

Real estate securities

Real estate securities are residential, commercial, CDO, and other asset-backed securities that are illiquid in nature and trade infrequently. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third-party dealer/pricing indications, to the extent available. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 5. Fair Value of Financial Instruments (continued)

and related inputs. Relevant market indicators that are factored in the analyses include bid/ask spreads, credit losses, interest rates, and prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. For September 30, 2011, we received dealer marks on 82% of our securities. In the aggregate, our internal valuations of the securities on which we received dealer marks were within 1% of the aggregate dealer marks.

Derivative assets and liabilities

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

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

Short-term debt

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

ABS issued

ABS issued includes asset-backed securities issued through our Sequoia, Acacia, and resecuritization 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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 5. Fair Value of Financial Instruments (continued)

available, bid/ask spreads, external spreads, collateral credit losses, interest rates and collateral prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. For September 30, 2011, we received dealer marks on 93% of our ABS issued. Our internal valuations of our ABS issued on which we received dealer marks were 3% 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).

REO

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

Note 6. Residential Real Estate Loans

We invest in residential real estate loans that we acquire from third-party originators. These loans are financed through the Sequoia entities that we sponsor or with equity and long-term debt. We do not currently service any residential loans, although we may from time to time acquire the rights to service loans purchased from third-party originators. The following table summarizes the classifications and carrying value of the residential real estate loans at September 30, 2011 and December 31, 2010.

September 30, 2011 (In Thousands)	Redwood	Sequoia	Total
Held-for-sale	$ 2,178	$	$ 2,178
Held-for-investment	226,728	3,928,677	4,155,405
Total Residential Real Estate Loans	$ 228,906	$ 3,928,677	$ 4,157,583

December 31, 2010 (In Thousands)	Redwood	Sequoia	Total
Held-for-sale	$ 1,855	$	$ 1,855
Held-for-investment	253,081	3,542,159	3,795,240
Total Residential Real Estate Loans	$ 254,936	$ 3,542,159	$ 3,797,095

Residential Real Estate Loans Held-for-Sale

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 6. Residential Real Estate Loans (continued)

Residential Real Estate Loans Held-for-Investment

During the three and nine months ended September 30, 2011, we purchased $402 million and $656 million, respectively, of residential loans in connection with our Sequoia securitization program. The following table provides additional information for total residential real estate loans held-for-investment at September 30, 2011 and December 31, 2010.

(In Thousands)	September 30, 2011	December 31, 2010
Principal balance	$ 4,181,061	$ 3,815,273
Unamortized premium, net	38,341	42,399
Recorded investment	4,219,402	3,857,672
Allowance for loan losses	(63,997)	(62,432)
Carrying Value	$ 4,155,405	$ 3,795,240

Of the $4.2 billion of principal value and $38 million of unamortized premium on loans held-for-investment at September 30, 2011, $1.6 billion of principal value and $24 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the first nine months of 2011, 6% of these residential loans prepaid and we amortized 14% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal value was $2.6 billion and the unamortized premium was $14 million. During the first nine months of 2011, 7% of these loans prepaid and we amortized 9% of the premium.

Of the $3.8 billion of principal value and $42 million of unamortized premium on loans held-for-investment at December 31, 2010, $1.7 billion of principal value and $27 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal value was $2.1 billion and the unamortized premium was $15 million.

Allowance for Loan Losses on Residential Loans

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

Activity in the Allowance for Loan Losses on Residential Loans

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2011	2010	2011	2010
Balance at beginning of period	$ 62,306	$ 61,478	$ 62,432	$ 54,220
Charge-offs, net	(2,287)	(4,822)	(6,802)	(11,361)
Provision for loan losses	3,978	2,436	8,367	16,233
Balance at End of Period	$ 63,997	$ 59,092	$ 63,997	$ 59,092

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 6. Residential Real Estate Loans (continued)

During the three months ended September 30, 2011 and 2010, there were $2 million and $5 million of charge-offs, respectively, in our residential loan portfolio that reduced our allowance for loan losses. These charge-offs arose from $8 million and $15 million of defaulted loan principal, respectively. During the nine months ended September 30, 2011 and 2010, there were $7 million and $11 million of charge-offs, respectively, in our residential loan portfolio that reduced our allowance for loan losses. These charge-offs arose from $23 million and $36 million of defaulted loan principal, respectively. For the three and nine months ended, September 30, 2011, we did not record any interest income on individually impaired loans.

Residential Loans Collectively Evaluated for Impairment

We collectively evaluate most of our residential loans for impairment. The following table summarizes the balances for loans collectively evaluated for impairment at September 30, 2011 and December 31, 2010.

(In Thousands)	September 30, 2011	December 31, 2010
Principal balance	$ 4,169,133	$ 3,801,921
Recorded investment	4,208,153	3,844,372
Related allowance	60,795	57,804

The following table summarizes the recorded investment and past due status of residential loans collectively evaluated for impairment at September 30, 2011 and December 31, 2010.

(In Thousands)	30 59 Days Past Due	60 89 Days Past Due	90+ Days Past Due	Current	Total Loans
September 30, 2011	$ 61,166	$ 14,946	$ 133,450	$ 3,998,591	$ 4,208,153
December 31, 2010	65,708	21,674	133,695	3,623,295	3,844,372

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

which is based on our historical loss experience as well as consideration of the loss factors described in *Note 3*.

Residential Loans Individually Evaluated for Impairment

If a loan is determined to be a TDR, it is removed from the general loan pools used for calculating the allowance for residential loan losses and assessed for impairment on an individual basis primarily based on any adverse change in the expected future cash flows resulting from the restructuring. The average recorded investment of loans individually evaluated for impairment for the three and nine months ended September 30, 2011 was $11 million and $12 million, respectively. The average recorded investment of loans individually evaluated for impairment for the three and nine months ended September 30, 2010 was $12 million and $10 million, respectively.

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

Note 6. Residential Real Estate Loans (continued)

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

(In Thousands)	September 30, 2011	December 31, 2010
Principal balance	$ 11,928	$ 13,352
Recorded investment	11,249	13,300
Related allowance	3,202	4,628

The following table summarizes the recorded investment and past due status of residential loans individually evaluated for impairment at September 30, 2011 and December 31, 2010.

(In Thousands)	30 59 Days Past Due	60 89 Days Past Due	90+ Days Past Due	Current	Total Loans
September 30, 2011	$ 710	$ 1,023	$ 1,331	$ 8,185	$ 11,249
December 31, 2010	2,604		1,046	9,650	13,300

Credit Characteristics of Residential Loans Held-for-Investment

As a percentage of total recorded investment, 99% of residential loans held-for-investment at September 30, 2011, were first lien, predominately prime-quality loans at the time of origination. The remaining 1% of loans were second lien, home equity lines of credit. The weighted average original loan-to-value (LTV) ratio for our residential loans held-for-investment outstanding at September 30, 2011 was 66%. The weighted average Fair Isaac Corporation (FICO) score for the borrowers of these loans (at origination) was 739.

We consider the year of origination of our residential loans held-for-investment to be a general indicator of credit performance as loans originated in specific years often had similar product and credit characteristics. The following table displays the recorded investment and year of origination for residential loans held-for-investment at September 30, 2011 and December 31, 2010.

(In Thousands)	September 30, 2011	December 31, 2010

2003 & Earlier	$ 1,806,822	$ 1,939,618
2004	1,064,533	1,116,358
2005	128,508	136,481
2006	184,551	191,945
2007	65,364	75,136
2008		
2009	178,683	189,355
2010	403,451	208,779
2011	387,490	
Total Recorded Investment	$ 4,219,402	$ 3,857,672

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 7. Commercial Real Estate Loans

We invest in commercial real estate loans that we originate and service as well as loans that we acquire from third-party originators. These loans are financed with equity and long-term debt or through the Acacia entities that we sponsor. The following table summarizes the classifications and carrying value of the commercial real estate loans at September 30, 2011 and December 31, 2010.

September 30, 2011 (In Thousands)	Redwood	Acacia	Total Loans
Fair value	$	$ 12,563	$ 12,563
Held-for-investment	98,061		98,061
Total Commercial Real Estate Loans	$ 98,061	$ 12,563	$ 110,624

December 31, 2010 (In Thousands)	Redwood	Acacia	Total Loans
Fair value	$	$ 19,850	$ 19,850
Held-for-investment	30,536		30,536
Total Commercial Real Estate Loans	$ 30,536	$ 19,850	$ 50,386

Commercial Real Estate Loans at Fair Value

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

Commercial Real Estate Loans Held-for-Investment

Commercial real estate loans held-for-investment are loans we originate or acquire from third party-originators. At September 30, 2011, there were twelve commercial real estate loans held-for-investment with an outstanding principal value of $99 million and a carrying value of $98 million. Of the $98 million commercial loans held-for-investment at September 30, 2011, 69% were originated in 2011, 31% were originated in 2010, and less than 1% were acquired in 2004. At December 31, 2010, there were four commercial real estate loans held-for-investment with an outstanding principal value and carrying value of $31 million. Of the $31 million of recorded investment in commercial loans held-for-investment at December 31, 2010, 99% were originated in the fourth quarter of 2010 and 1% were originated

in 2004.

Allowance for Loan Losses on Commercial Loans

For commercial real estate loans classified as held-for-investment, we establish and maintain an allowance for loan losses for any loans we have determined to be impaired. At September 30, 2011 and December 31, 2010, there were no delinquent or impaired commercial loans.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS September 30, 2011 (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 at September 30, 2011 and December 31, 2010.

September 30, 2011 (In Thousands)	Redwood	The Fund	Acacia	Securities
Residential	$ 770,164	$	$ 199,590	$ 969,754
Commercial	5,887		39,072	44,959
CDO	1,010		17,530	18,540
Total Real Estate Securities	$ 777,061	$	$ 256,192	$ 1,033,253

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 8. Real Estate Securities (continued)

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

September 30, 2011	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$	$ 3,327	$ 3,327	$ 276,925	$	$ 276,925
Residential non-prime	20,756	100,238	120,994	278,161		278,161
Commercial		11,216	11,216			
Total Senior Securities	20,756	114,781	135,537	555,086		555,086
Re-REMIC Securities				113,100		113,100
Subordinate Securities						
Residential prime	328	36,987	37,315	70,277		70,277
Residential non-prime	155	59,038	59,193	10,462		10,462
Commercial		27,856	27,856	5,887		5,887
CDO	960	17,530	18,490	50		50
Total Subordinate Securities	1,443	141,411	142,854	86,676		86,676
Total Real Estate Securities	$ 22,199	$ 256,192	$ 278,391	$ 754,862	$	$ 754,862

December 31, 2010	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$	$ 4,412	$ 4,412	$ 315,891	$	$ 315,891
Residential non-prime	19,742	117,623	137,365	326,365	12,915	339,280
Commercial		11,000	11,000			
Total Senior Securities	19,742	133,035	152,777	642,256	12,915	655,171
Re-REMIC Securities				85,077		85,077
Subordinate Securities						
Residential prime	386	49,620	50,006	53,846		53,846
Residential non-prime	188	76,839	77,027	13,188	6,096	19,284
Commercial		32,828	32,828	7,496		7,496
CDO	1,038	16,041	17,079		4,245	4,245
Total Subordinate Securities	1,612	175,328	176,940	74,530	10,341	84,871

Total Real Estate Securities	$ 21,354	$ 308,363	$ 329,717	$ 801,863	$ 23,256	$ 825,119

Senior securities are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Of the senior securities owned at Redwood at September 30, 2011, $185 million of prime securities and $165 million of non-prime securities were financed through a non-recourse resecuritization entity, as discussed in *Note 4*. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 8. Real Estate Securities (continued)

For purposes of the table above, the prime or non-prime designation used to categorize our residential securities is based upon the general credit characteristics of the residential loans underlying each security at the time of origination. For example, prime residential loans are generally characterized by lower LTV ratios, and are made to borrowers with higher FICO scores. Non-prime residential loans are generally characterized by higher LTV ratios and may have been made to borrowers with lower credit scores or impaired credit histories (while exhibiting the ability to repay their loans). Regardless of whether or not the loans backing a mortgage-backed security were designated as prime or non-prime at origination, there is a risk that the borrower may not be able to repay the loan.

We elected the fair value option for certain securities at Redwood and the Acacia entities, and classify them as trading securities. The unpaid principal balance of these Acacia trading securities was $1.14 billion and $1.55 billion at September 30, 2011 and December 31, 2010, respectively.

AFS Securities

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

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

September 30, 2011 (In Thousands)	Residential	Commercial	CDO	Total
Principal balance	$ 1,135,145	$ 54,061	$ 10,689	$ 1,199,895
Credit reserve	(252,854)	(47,197)	(9,607)	(309,658)
Net unamortized (discount)	(229,521)	(2,551)	(1,082)	(233,154)
Amortized cost	652,770	4,313		657,083
Gross unrealized gains	112,818	1,788	50	114,656
Gross unrealized losses	(16,663)	(214)		(16,877)
Carrying Value	$ 748,925	$ 5,887	$ 50	$ 754,862

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 8. Real Estate Securities (continued)

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

Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

Three Months Ended September 30, 2011 (In Thousands)	Residential		Commercial		CDO	
	Credit Reserve	Unamortized Discount, Net	Credit Reserve	Unamortized Discount, Net	Credit Reserve	Unamortized Premium, Net
Beginning balance June 30, 2011	$240,899	$243,662	$48,987	$4,362	$10,780	$1,083
Amortization of net (discount) premium		(10,138)		(69)		26
Realized credit losses	(19,258)		(4,066)		(1,200)	
Acquisitions	17,104	10,388				
Sales, calls, other	(329)	(502)				
Impairments	549		534			
Transfers to (release of) credit reserves	13,889	(13,889)	1,742	(1,742)	27	(27)
Ending Balance September 30, 2011	$252,854	$229,521	$47,197	$2,551	$9,607	$1,082

Nine Months Ended September 30, 2011 (In Thousands)	Residential		Commercial		CDO	
	Credit Reserve	Unamortized Discount, Net	Credit Reserve	Unamortized Discount, Net	Credit Reserve	Unamortized Discount, Net
Beginning balance December 31, 2010	$297,849	$291,093	$76,979	$5,591	$88,394	$(11,485)
Amortization of net discount		(32,602)		(138)		(59)
Realized credit losses	(75,523)		(30,018)		(4,205)	
Acquisitions	18,280	21,989				
Sales, calls, other	(20,517)	(21,379)	(2,653)	(1,439)	(74,662)	12,146
Impairments	3,185		1,426		560	

Transfers to (release of) credit reserves	29,580	(29,580)	1,463	(1,463)	(480)	480
Ending Balance September 30, 2011	$252,854	$229,521	$47,197	$2,551	$9,607	$1,082

The loans underlying our residential subordinate securities totaled $26 billion at September 30, 2011. These loans are located nationwide with a large concentration in California (41%). Serious delinquencies (90+ days, in foreclosure or REO) at September 30, 2011 were 5.74% of current principal balances. The loans underlying our commercial subordinate securities totaled $19 billion at September 30, 2011, and consist primarily of office (29%), retail (35%), and multifamily (12%) loans. These loans are located nationwide with the highest concentration in California (15%). Serious delinquencies (60+ days, in foreclosure or REO) at September 30, 2011 were 6.0% of current principal balances.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 8. Real Estate Securities (continued)

AFS Securities with Unrealized Losses

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

September 30, 2011 (In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
Residential	$ 173,195	$ (6,332)	$ 166,863	$ 58,509	$ (10,331)	$ 48,178
Commercial	422	(67)	355	1,085	(147)	938
CDO						
Total Securities	$ 173,617	$ (6,399)	$ 167,218	$ 59,594	$ (10,478)	$ 49,116

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

At September 30, 2011, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 438 AFS securities, of which 90 were in an unrealized loss position and 21 were in a continuous unrealized loss position for twelve consecutive months or longer. At December 31, 2010, our consolidated balance sheet included 509 AFS securities, of which 80 were in a continuous unrealized loss position, of which 46 were in a continuous unrealized loss position for twelve consecutive months or longer.

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

Evaluating AFS Securities for Other-than-Temporary Impairments

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

Significant Valuation Assumptions

	Range for Securities		
September 30, 2011	Prime	Non-prime	Commercial
Prepayment rates	4 15%	2 10%	N/A
Loss severity	16 57%	22 56%	33 50%
Projected losses	0 32%	1 40%	2 7%

The credit component of OTTI is recognized through our consolidated statement of income as a component of market valuation adjustments, net, while the non-credit component of OTTI is recognized through accumulated other comprehensive income, a component of equity. Total credit OTTI for the three and nine months ended September 30, 2011 was $1 million and $5 million, respectively. Total non-credit OTTI for the three and nine months ended September 30, 2011 was less than $1 million and $2 million, respectively.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS September 30, 2011 (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 September 30, 2011 and 2010.

Activity of Credit Component of Other-than-Temporary Impairments

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Balance at beginning of period	$90,019	$132,030	$121,016	$146,454
Additions				
Initial credit impairments	519	377	982	680
Subsequent credit impairments	217	2,174	1,152	6,613
Reductions				
Securities sold, or expected to sell			(12,317)	(5,113)
Securities with no outstanding principal at period end	(11,056)	(7,086)	(31,134)	(21,139)
Balance at End of Period	$79,699	$127,495	$79,699	$127,495

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

Gross Realized Gains and Losses

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

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010

Gross realized gains sales	$	$ 22	$ 12,665	$ 56,546
Gross realized gains calls	832	1,494	1,365	1,494
Gross realized losses sales			(3,523)	(3,335)
Gross realized losses calls			(223)	
Total Realized Gains on Sales and Calls of AFS Securities, net	$ 832	$ 1,516	$ 10,284	$ 54,705

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 9. Derivative Financial Instruments

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

September 30, 2011 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Assets Risk Management Derivatives						
Interest rate swaps	$	$	$912	$5,601	$912	$5,601
TBAs	289	124,000			289	124,000
Futures	13	126,000			13	126,000
Interest rate caps purchased			1,504	703,400	1,504	703,400
Total Assets	302	250,000	2,416	709,001	2,718	959,001
Liabilities Cash Flow Hedges						
Interest rate swaps	(51,977)	165,000			(51,977)	165,000
Liabilities Risk Management Derivatives						
Interest rate swaps	(4,875)	154,500	(67,902)	582,794	(72,777)	737,294
TBAs	(2,397)	301,000			(2,397)	301,000
Futures	(69)	198,000			(69)	198,000
Total Liabilities	(59,318)	818,500	(67,902)	582,794	(127,220)	1,401,294
Total Derivative Financial Instruments, Net	$(59,016)	$1,068,500	$(65,486)	$1,291,795	$(124,502)	$2,360,295

December 31, 2010 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Assets Risk Management Derivatives						
Interest rate swaps	$175	$44,000	$813	$18,037	$988	$62,037
TBAs	348	35,000			348	35,000
Futures	703	433,000			703	433,000

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 9. Derivative Financial Instruments (continued)

Risk Management Derivatives

To offset to varying degrees the changes in the value of mortgage products to which we have exposure, we may enter into interest rate agreements, TBA contracts, and Eurodollar futures contracts.

Certain Risks Related to Unsecuritized Residential and Commercial Loans at Redwood

In order to manage certain risks associated with residential loans we own or plan to acquire and securitize, and commercial loans we invest in, at September 30, 2011, we were party to interest rate agreements with an aggregate notional amount of $154 million, TBA contracts sold, net with a notional amount of $177 million, and financial futures with an aggregate notional amount of $324 million. Net negative market valuation adjustments on these derivatives were $13 million and $16 million for the three and nine months ended September 30, 2011, respectively.

Certain Risks Related to Liabilities at Acacia Entities

Net valuation adjustments on interest rate agreements at Acacia were negative $10 million and negative $18 million for the three months ended September 30, 2011 and 2010, respectively. Net valuation adjustments on interest rate agreements at Acacia were negative $24 million and negative $59 million for the nine months ended September 30, 2011 and 2010, respectively.

Derivatives Designated as Cash Flow Hedges

To hedge the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated interest rate swaps as cash flow hedges during 2010 and during the second quarter of 2011 with an aggregate notional balance of $165 million. For the three and nine months ended September 30, 2011, these hedges decreased in value by $38 million and $40 million, respectively, which was recorded as a decrease to accumulated other comprehensive income, a component of equity.

For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was $65 million at September 30, 2011 and $29 million at December 31, 2010. For both the three months ended September 30, 2011 and 2010 we reclassified $1 million of unrealized losses on derivatives to interest expense. For both the nine months ended September 30, 2011 and 2010, we reclassified $3 million of unrealized losses on derivatives to interest expense.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2011	2010	2011	2010
Net interest expense on cash flow interest rate agreements	$(1,637)	$(1,486)	$(4,803)	$(2,523)
Realized net (expense) income due to net ineffective portion of hedges	(5)	19	(18)	(7)
Realized net losses reclassified from other comprehensive income	(1,067)	(1,058)	(3,211)	(2,604)
Total Interest Expense	$(2,709)	$(2,525)	$(8,032)	$(5,134)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 9. Derivative Financial Instruments (continued)

Credit Derivatives

At September 30, 2011 and December 31, 2010, we had no outstanding CDS contracts or obligations. During the nine months ended September 30, 2010, the reference securities underlying our CDS experienced principal losses and corresponding obligations of $20 million.

Derivative Counterparty Credit Risk

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

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

Note 10. Other Assets

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

Other Assets

(In Thousands)	September 30, 2011	December 31, 2010
REO	$ 6,554	$ 14,481
Fixed assets and leasehold improvements	2,967	3,692

Margin posted, net	57,080	16,233
Investment receivable	2,241	883
Income tax receivables	4,736	1,243
Prepaid expenses	2,221	1,973
Other	381	157
Total Other Assets	$ 76,180	$ 38,662

REO consists of foreclosed properties received in full satisfaction of defaulted real estate loans. The carrying value of REO at September 30, 2011 was $7 million, which includes the net effect of $8 million related to transfers into REO during the first nine months of 2011, offset by $15 million of REO liquidations and $1 million of negative market valuation adjustments. At September 30, 2011, there were 49 REO properties recorded on our consolidated balance sheet, all of which were owned at Sequoia. At December 31, 2010, there were 83 REO properties recorded on our balance sheet, of which 81 were owned at Sequoia and two were owned at Redwood. Properties located in Michigan, Georgia, Ohio, and California accounted for 65% of our REO properties at September 30, 2011.

Margin posted, net, was $57 million at September 30, 2011, resulting from margin calls from our swap and master repurchase agreement counterparties that required us to post collateral.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 11. Short-term Debt

At September 30, 2011, we had no short-term debt outstanding. For the three months ended September 30, 2011, the average balance of short-term debt outstanding was $18 million, with a weighted average interest rate of 1.72%. For the nine months ended September 30, 2011, the average balance of short-term debt outstanding was $23 million, with a weighted average interest rate of 1.58%. At December 31, 2010, we had short-term debt outstanding of $44 million, which was repaid in March 2011.

Note 12. Asset-Backed Securities Issued

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

In 2011, we securitized $671 million of loans through our Sequoia program and issued $640 million of ABS to third-parties. In July 2011, we transferred $365 million of residential securities into a resecuritization, with $245 million of ABS issued to third-parties. The components of ABS issued by consolidated securitization entities we sponsored at September 30, 2011 and December 31, 2010, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

	September 30, 2011			
(In Thousands)	Sequoia	Acacia	Resecuritization	Total
Certificates with principal balance	$3,813,642	$2,894,156	$ 232,006	$6,939,804
Interest-only certificates	17,950			17,950
Unamortized premium	1,357			1,357
Unamortized discount	(6,166)			(6,166)
Fair value adjustment, net		(2,659,921)		(2,659,921)
Total ABS Issued	$3,826,783	$234,235	$ 232,006	$4,293,024
Range of weighted average interest rates, by series	0.38% to 4.39%	0.76% to 1.93%	2.19%	

Stated maturities	2014 2047	2039 2052	2046
Number of series	39	10	1

(In Thousands)	December 31, 2010 Sequoia	Acacia	Resecuritization	Total
Certificates with principal balance	$3,445,882	$2,956,657	$	$6,402,539
Interest-only certificates	15,587			15,587
Unamortized premium	1,726			1,726
Unamortized discount	(4,694)			(4,694)
Fair value adjustment, net		(2,653,580)		(2,653,580)
Total ABS Issued	$3,458,501	$303,077	$	$3,761,578
Range of weighted average interest rates, by series	0.45% to 4.40%	0.76% to 1.88%		
Stated maturities	2014 2047	2039 2052		
Number of series	37	10		

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 12. Asset-Backed Securities Issued (continued)

The maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of ABS issued will often occur earlier than its stated maturity. At September 30, 2011, $4.2 billion of ABS issued ($6.89 billion principal balance) had contractual maturities of over five years and $51 million of ABS issued ($51 million principal balance) had contractual maturities of one to five years. Amortization of the resecuritization and Sequoia deferred ABS issuance costs was $1 million and $2 million for the nine months ended September 30, 2011 and 2010, respectively.

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

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	September 30, 2011	December 31, 2010
Sequoia	$ 4,236	$ 2,356
Acacia	2,687	2,911
Resecuritization	72	
Total Accrued Interest Payable on ABS Issued	$ 6,995	$ 5,267

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

Collateral for Asset-Backed Securities Issued

	September 30, 2011			
(In Thousands)	Sequoia	Acacia	Resecuritization	Total
Real estate loans	$ 3,928,677	$ 12,563	$	$ 3,941,240
Real estate securities		272,222	349,764	621,986
REO	6,554			6,554
Restricted cash	283	16,632		16,915
Accrued interest receivable	7,925	2,082	987	10,994

Total Collateral for ABS Issued	$ 3,943,439	$ 303,499	$ 350,751	$ 4,597,689

	December 31, 2010			
(In Thousands)	Sequoia	Acacia	Resecuritization	Total
Real estate loans	$ 3,542,159	$ 19,850	$	$ 3,562,009
Real estate securities		327,919		327,919
Other investments				
REO	14,241			14,241
Restricted cash	331	21,790		22,121
Accrued interest receivable	6,264	2,735		8,999
Total Collateral for ABS Issued	$ 3,562,995	$ 372,294	$	$ 3,935,289

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Note 13. Long-Term Debt

In 2006, we issued $100 million of trust preferred securities through Redwood Capital Trust I, a Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating coupon rate equal to three-month LIBOR plus 2.25% until the notes are redeemed, which will be no later than January 30, 2037. The interest expense yield on our trust preferred securities was 2.62% and 3.34% for the nine months ended September 30, 2011 and 2010, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our trust preferred securities was 6.88% for the nine months ended September 30, 2011. The earliest optional redemption date without penalty is January 30, 2012. In December 2010, we repurchased $500 thousand principal amount of these trust preferred securities.

In 2007, we issued an additional $50 million of subordinated notes. These subordinated notes require quarterly distributions at a floating interest rate equal to three-month LIBOR plus 2.25% until the notes are redeemed, which will be no later than July 30, 2037. The interest expense yield on our subordinated notes was 2.62% and 3.34% for the nine months ended September 30, 2011 and 2010, respectively. Including hedging costs, and amortization of deferred securities issuance costs, the interest expense yield on our trust preferred securities was 6.88% for the nine months ended September 30, 2011. The earliest optional redemption date without a penalty is July 30, 2012. In July 2009, we repurchased $10 million principal amount of this subordinated debt.

At both September 30, 2011 and December 31, 2010, the accrued interest payable balance on long-term debt was less than $1 million. Under the terms of our long-term debt, we covenant to, among other things, use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of our long-term debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is *pari passu* or subordinate to our long-term debt.

Note 14. Commitments and Contingencies

Lease Commitments

At September 30, 2011, we were obligated under non-cancelable operating leases with expiration dates through 2018 for $11 million. Operating lease expense was $1 million for both the nine months ended September 30, 2011 and 2010.

The following table presents our future lease commitments at September 30, 2011, giving effect to the amendment.

Future Lease Commitments by Year

(In Thousands)	September 30, 2011
2011 (three months)	$ 533
2012	1,913
2013	1,759
2014	1,800
2015	1,756
2016 and thereafter	3,691
Total	$ 11,452

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 14. Commitments and Contingencies (continued)

In the third quarter of 2011, we entered into a follow-on lease agreement for our executive office. The new lease, which goes into effect in the second quarter of 2012, will replace our existing lease at that time and expire in 2018. The total payments required under both the current and follow-on lease will be recognized as office rent expense on a straight-line basis over the respective lease terms. In the third quarter of 2011, we also relocated our New York office and entered into a new lease agreement. This lease expires in 2015 and accounts for approximately ten percent of our future lease obligation.

Leasehold improvements for our offices are amortized into expense over the prior lease term, expiring in 2012. The unamortized leasehold improvement balance was $2 million and $3 million, respectively, at September 30, 2011 and December 31, 2010.

Loss Contingencies Litigation

On December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants). The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, *et seq.*) and seeks to rescind the purchase of a mortgage pass-through certificate (or, residential mortgage backed securities, RMBS) issued through our Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction and purchased by the FHLB-Seattle. The FHLB-Seattle also seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys fees and costs. On June 10, 2010, the FHLB-Seattle filed an amended complaint. Subsequently, on October 18, 2010, the FHLB-Seattle Defendants filed motions to dismiss the FHLB-Seattle s complaint. Redwood Trust, Inc. and SRF additionally moved to dismiss the complaint for lack of personal jurisdiction. The FHLB-Seattle alleges that the FHLB-Seattle Defendants offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the loans securitized in this transaction. Among other things, the FHLB-Seattle alleges that the FHLB-Seattle Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these 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. In a series of rulings issued between June 23, 2011 and August 15, 2011, the Washington State Superior Court dismissed the allegations relating to occupancy status and denied other grounds for dismissal. On July 19, 2011, the Court granted Redwood Trust, Inc. s and SRF s motion to dismiss for lack of personal jurisdiction. Redwood Trust, Inc. does not know whether the FHLB-Seattle will appeal or otherwise contest the dismissal, or file a claim in another jurisdiction. The Sequoia RMBS that is the subject of the FHLB-Seattle s claim was issued with an original principal balance of approximately $133 million and, at September

30, 2011, had a remaining outstanding principal balance of approximately $29 million. We believe that this claim is without merit and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Seattle s claim, Redwood agreed to indemnify the underwriters of this RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle s claims against the underwriters of this RMBS were not dismissed for lack of personal jurisdiction. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 14. Commitments and Contingencies (continued)

misrepresentation under California state law and seeks unspecified damages and attorneys fees and costs with respect to a RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction (which is the same transaction at issue in the litigation initiated by the FHLB-Seattle described in the preceding paragraph). Among other things, Schwab alleges that the offering materials for this Sequoia RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. On September 22, 2011, the Schwab Defendants moved to dismiss the complaint, which motions are now pending. The Sequoia RMBS that is the subject of Schwab s claim was issued with an original principal balance of approximately $14.8 million and, at September 30, 2011, had a remaining outstanding principal balance of approximately $3.2 million. We believe that this case is without merit and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of Schwab s claim, Redwood agreed to indemnify the underwriters of this RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On July 12, 2010, two notices of Election to Void Sale of Securities pursuant to Illinois Securities Law (815 ILCS Section 5/13(A)) were received from the Federal Home Loan Bank of Chicago (FHLB-Chicago). In the notices, the FHLB-Chicago sought to void its purchase of two RMBS that were issued in 2006 by a securitization trust with respect to which Redwood Trust, Inc. s subsidiary, SRF, was the depositor. Subsequently, on October 15, 2010, the FHLB-Chicago filed a claim in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the FHLB-Chicago Defendants) in relation to RMBS sold or issued by the FHLB-Chicago Defendants or by entities controlled by the FHLB-Chicago Defendants. In an amended complaint filed on March 16, 2011, FHLB-Chicago added as defendants Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc. With respect to Redwood Trust, Inc. and SRF, the FHLB-Chicago alleges that the offering materials for two RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2006-1 securitization transaction contained untrue and misleading statements and material representations in violation of Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law (N.C.G.S.A. § 78A-8(2) & § 78A-56(a)) and also alleges a claim of negligent misrepresentations under Illinois common law. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of these RMBS and to collect interest on the original purchase price at the statutory interest rate of 10% per annum from the date of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys fees and costs. Among other things, the FHLB-Chicago alleges that the offering materials for this RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this

transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, (4) ratings assigned to these RMBS, and (5) due diligence performed on these mortgage loans. The first of these two Sequoia RMBS was issued with an original principal balance of approximately $105 million and, at September 30, 2011, had a remaining outstanding principal balance of approximately $43 million. The second of these two Sequoia RMBS was issued with an original principal balance of approximately $379 million and, at September 30, 2011, had a remaining outstanding principal balance of approximately $155 million. On March 27, 2011, the FHLB-Chicago Defendants moved to dismiss the amended complaint, which motions are now pending. We believe that this case is without merit, and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 14. Commitments and Contingencies (continued)

subject of the FHLB-Chicago s claim, Redwood agreed to indemnify the underwriters of these RMBS for certain losses and expenses they might incur as a result of claims made against them relating to these RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

We cannot determine the outcome of any of the above-referenced litigation matters at this time or predict the results with certainty. We cannot be certain that any of these matters will not have a material adverse effect on our results of operations in any future period, and any loss or expense related to any of this litigation 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. If, with respect to a matter, it is not both probable to result in liability and the amount of loss cannot be reasonably estimated (as is the case for each of the above-referenced litigation matters), FASB guidance on accounting for contingencies provides that an estimate of possible loss or range of loss be disclosed unless such an estimate cannot be made. There are numerous factors that make it difficult to meaningfully estimate possible loss or range of loss at this stage of these litigation matters, including that: the proceedings are in relatively early stages, there are significant factual and legal issues to be resolved, information obtained or rulings made during the lawsuits could affect the methodology for calculation of rescission and the related statutory interest rate, our belief that these litigations are without merit, and our intent to defend these actions vigorously. In addition, with respect to claims where damages are the requested relief, no amount of loss or damages has been specified. We also may have additional rights and/or obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters. These rights and obligations could offset or increase our potential losses. We are unable at this time to estimate the potential amount of any such offset or loss.

Note 15. Equity

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

Stockholders Equity

(In Thousands)	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Balance at beginning of period	$ 1,024,510	$ 1,064,753
Net income attributable to Redwood Trust, Inc.	1,297	28,901
Distributions to shareholders	(20,114)	(60,474)
Unrealized gains on securities and derivatives, net	(48,312)	(80,030)
Other changes in equity, net	1,564	5,795
Balance at End of Period	$ 958,945	$ 958,945

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

Note 15. Equity (continued)

Accumulated Other Comprehensive Income

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

(In Thousands)	September 30, 2011	December 31, 2010
Net unrealized gains on real estate securities	$ 97,779	$ 137,360
Less: Unrealized losses attributable to noncontrolling interest		(4,164)
Net unrealized gains on real estate securities recognized in equity	97,779	141,524
Net unrealized losses on interest rate agreements accounted for as cash flow hedges	(65,470)	(29,185)
Total Accumulated Other Comprehensive Income	$ 32,309	$ 112,339

Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership (LP) interests in the Fund held by third-parties. During the second quarter of 2011, the Fund sold all remaining securities and during the third quarter of 2011, the Fund distributed all remaining cash to investors, and had no assets or liabilities at September 30, 2011. There was no noncontrolling interest on our consolidated balance sheet at September 30, 2011. Of the total equity recorded on our consolidated balance sheet at December 31, 2010, $11 million was noncontrolling interest. Income allocated to the noncontrolling interest is based on the 48% third-party LP ownership percentage. The ownership percentage is determined by dividing the number of units held by third-party LP investors by the total units outstanding.

Earnings Per Common Share

The following table provides the basic and diluted earnings per common share computations for the three and nine months ended September 30, 2011 and 2010.

Basic and Diluted Earnings Per Common Share

(In Thousands, Except Share Data)	Three Months Ended September 30, 2011	2010	Nine Months Ended September 30, 2011	2010
Basic Earnings Per Common Share:				
Net income attributable to Redwood	$1,297	$19,898	$28,901	$95,343
Less: Dividends and undistributed earnings allocated to participating securities	520	539	1,659	2,655
Net income allocated to common shareholders	$777	$19,359	$27,242	$92,688
Basic weighted average common shares outstanding	78,470,625	77,901,970	78,275,796	77,794,106
Basic Earnings Per Common Share	$0.01	$0.25	$0.35	$1.19
Diluted Earnings Per Common Share:				
Net income attributable to Redwood	$1,297	$19,898	$28,901	$95,343
Less: Dividends and undistributed earnings allocated to participating securities	520	541	1,659	2,235
Net income allocated to common shareholders	$777	$19,357	$27,242	$93,108
Basic weighted average common shares outstanding	78,470,625	77,901,970	78,275,796	77,794,106
Net effect of dilutive equity awards		1,059,235		969,583
Diluted weighted average common shares outstanding	78,470,625	78,961,205	78,275,796	78,763,689
Diluted Earnings Per Common Share	$0.01	$0.25	$0.35	$1.18

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 15. Equity (continued)

For the three and nine months ended September 30, 2011, there were no dilutive equity awards determined under the two-class method as dividend distributions were greater than net income for each of these periods. Therefore, diluted earnings per common share was computed in the same manner as basic earnings per share. For the three and nine months ended September 30, 2010, there were 1,059,235 and 969,583, respectively, of dilutive equity awards determined under the two-class method. We included participating securities in the calculation of diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method. For the three and nine months ended September 30, 2011, the number of outstanding equity awards that were antidilutive totaled 1,689,546 and 1,850,659, respectively, under the two-class method. For the three and nine months ended September 30, 2010, the number of outstanding equity awards that were antidilutive totaled 648,963 and 590,578, respectively, under the two-class method. There were no other participating securities during these periods.

Stock Repurchases

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the three and nine months ended September 30, 2011, there were 222,386 shares acquired under the plan. At September 30, 2011, there remained 4,435,685 shares available for repurchase under this plan.

Note 16. Equity Compensation Plans

At September 30, 2011 and December 31, 2010, 1,192,148 and 1,052,826 shares of common stock, respectively, were available for grant under Redwood s Incentive Plan. The unamortized compensation cost under the Incentive Plan and the Employee Stock Purchase Plan totaled $13 million at September 30, 2011, as shown in the following table.

	Nine Months Ended September 30, 2011					
(In Thousands)	Stock Options	Restricted Stock	Deferred Stock Units	Performance Stock Units	Employee Stock Purchase Plan	Total
Unrecognized compensation cost at beginning of period	$	$ 1,390	$ 14,420	$ 3,320	$	$ 19,130
Equity grants		7	637		120	764
Equity compensation cost		(355)	(5,397)	(854)	(90)	(6,696)

Unrecognized Compensation Cost at End of Period	$	$ 1,042	$ 9,660	$ 2,466	$ 30	$ 13,198

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

Stock Options

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

For the three and nine months ended September 30, 2011 and 2010, there were no stock options exercised. For the nine months ended September 30, 2010, there were 11,500 stock options exercised with an intrinsic value or gain (fair market value less exercise price) of a negligible amount.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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

Note 16. Equity Compensation Plans (continued)

Restricted Stock

At September 30, 2011 and December 31, 2010, there were 100,871 and 119,071 shares, respectively, of restricted stock awards outstanding. Restrictions on these shares lapse through 2015. There were no restricted stock awards granted during the three months ended September 30, 2011. There were 1,647 restricted stock awards granted during the nine months ended September 30, 2011.

Deferred Stock Units

At September 30, 2011 and December 31, 2010, there were 1,943,599 and 2,351,804 DSUs outstanding, respectively, of which 1,000,963 and 1,042,341, respectively, had vested. There were 5,803 and 65,971 DSUs granted during the three and nine months ended September 30, 2011, respectively. During the three and nine months ended September 30, 2011, the number of DSUs distributed to participants in the Executive Deferred Compensation Plan (EDCP) totaled 3,098 and 456,640, respectively. During the three months ended September 30, 2011, there were no cash distributions to participants in the EDCP. Cash distributions to EDCP participants of some of their previously deferred compensation totaled less than $1 million during the nine months ended September 30, 2011.

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

Performance Stock Units

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

Employee Stock Purchase Plan

The ESPP allows a maximum of 200,000 shares of common stock to be purchased in aggregate for all employees. At September 30, 2011 and December 31, 2010, 143,546 and 121,643 shares have been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

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

Note 17. Operating Expenses

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

Operating Expenses

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2011	2010	2011	2010
Fixed compensation expense	$ 3,702	$ 3,362	$ 11,643	$ 11,444
Variable compensation expense	863			