

REDWOOD TRUST INC
Form 10-Q
May 09, 2016

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
 OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: March 31, 2016

OR

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

For the Transition Period from _____ to _____.
Commission File Number 1-13759

REDWOOD TRUST, INC.
(Exact Name of Registrant as Specified in Its Charter)
Maryland 68-0329422
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

One Belvedere Place, Suite 300 94941
Mill Valley, California
(Address of Principal Executive Offices) (Zip Code)

(415) 389-7373
(Registrant's Telephone Number, Including Area Code)

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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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 76,964,286 shares outstanding as of May 2, 2016

REDWOOD TRUST, INC.
2016 FORM 10-Q REPORT
TABLE OF CONTENTS

	Page
<u>PART I</u> FINANCIAL INFORMATION	
Item 1. <u>Financial Statements</u>	<u>2</u>
<u>Consolidated Balance Sheets at March 31, 2016 (Unaudited) and December 31, 2015</u>	<u>2</u>
<u>Consolidated Statements of Income for the Three Months Ended March 31, 2016 and 2015 (Unaudited)</u>	<u>3</u>
<u>Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2016 and 2015 (Unaudited)</u>	<u>4</u>
<u>Consolidated Statements of Changes in Stockholders' Equity for the Three Months Ended March 31, 2016 and 2015 (Unaudited)</u>	<u>5</u>
<u>Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2016 and 2015 (Unaudited)</u>	<u>6</u>
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	<u>7</u>
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>61</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>104</u>
Item 4. <u>Controls and Procedures</u>	<u>105</u>
 <u>PART</u> <u>II</u> — OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	<u>106</u>
Item 1A. <u>Risk Factors</u>	<u>107</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>107</u>
Item 3. <u>Defaults Upon Senior Securities</u>	<u>107</u>
Item 4. <u>Mine Safety Disclosures (Not Applicable)</u>	<u>107</u>
Item 5. <u>Other Information</u>	<u>108</u>
Item 6. <u>Exhibits</u>	<u>109</u>
<u>Signatures</u>	<u>110</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)

(Unaudited)

ASSETS ⁽¹⁾

	March 31, 2016	December 31, 2015
Residential loans, held-for-sale, at fair value	\$441,076	\$ 1,115,738
Residential loans, held-for-investment, at fair value	3,273,980	2,813,065
Commercial loans, held-for-sale, at fair value	—	39,141
Commercial loans, held-for-investment (includes \$69,674 and \$67,657 at fair value)	363,893	363,506
Real estate securities, at fair value	919,927	1,233,256
Mortgage servicing rights, at fair value	126,620	191,976
Cash and cash equivalents	305,115	220,229
Total earning assets	5,430,611	5,976,911
Restricted cash	2,137	5,567
Accrued interest receivable	19,766	23,290
Derivative assets	31,975	16,393
Other assets	242,391	197,886
Total Assets	\$5,726,880	\$ 6,220,047

LIABILITIES AND EQUITY ⁽¹⁾

Liabilities

Short-term debt	\$804,175	\$ 1,855,003
Accrued interest payable	15,522	8,936
Derivative liabilities	97,468	62,794
Accrued expenses and other liabilities	82,169	69,897
Asset-backed securities issued (includes \$907,023 and \$996,820 at fair value), net ⁽²⁾	958,364	1,049,415
Long-term debt (includes \$65,181 and \$63,152 at fair value), net ⁽²⁾	2,683,432	2,027,737
Total liabilities	4,641,130	5,073,782

Equity

Common stock, par value \$0.01 per share, 180,000,000 shares authorized; 76,627,231 and 78,162,765 issued and outstanding	766	782
Additional paid-in capital	1,680,981	1,695,956
Accumulated other comprehensive income	56,712	91,993
Cumulative earnings	1,030,746	1,018,683
Cumulative distributions to stockholders	(1,683,455)	(1,661,149)
Total equity	1,085,750	1,146,265
Total Liabilities and Equity	\$5,726,880	\$ 6,220,047

Our consolidated balance sheets include assets of consolidated variable interest entities (“VIEs”) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have (1) recourse to Redwood Trust, Inc. or its affiliates. At March 31, 2016 and December 31, 2015, assets of consolidated VIEs totaled \$1,102,195 and \$1,195,574, respectively. At March 31, 2016 and December 31, 2015, liabilities of consolidated VIEs totaled \$959,464 and \$1,050,861, respectively. See Note 4 for further discussion.

At March 31, 2016 and December 31, 2015, Asset-backed securities issued, net included \$339 and \$542, (2) respectively, of deferred debt issuance costs, and long-term debt, net included \$9,513 and \$10,438, respectively, of deferred debt issuance costs.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data)	Three Months Ended March 31,	
(Unaudited)	2016	2015
Interest Income		
Residential loans	\$31,400	\$ 25,009
Commercial loans	9,460	10,914
Real estate securities	21,095	27,775
Other interest income	373	48
Total interest income	62,328	63,746
Interest Expense		
Short-term debt	(6,697)	(7,224)
Asset-backed securities issued	(4,282)	(6,202)
Long-term debt	(12,971)	(10,535)
Total interest expense	(23,950)	(23,961)
Net Interest Income	38,378	39,785
Provision for loan losses	(289)	(206)
Net Interest Income After Provision	38,089	39,579
Non-interest Income		
Mortgage banking activities, net	7,218	1,923
Mortgage servicing rights income (loss), net	6,281	(10,924)
Investment fair value changes, net	(19,538)	(1,145)
Other income	955	809
Realized gains, net	9,538	4,306
Total non-interest income (loss), net	4,454	(5,031)
Operating expenses	(30,452)	(25,063)
Net income before provision for income taxes	12,091	9,485
(Provision for) benefit from income taxes	(28)	5,316
Net Income	\$12,063	\$ 14,801
Basic earnings per common share	\$0.15	\$ 0.17
Diluted earnings per common share	\$0.15	\$ 0.16
Regular dividends declared per common share	\$0.28	\$ 0.28
Basic weighted average shares outstanding	77,137,683	83,360,312
Diluted weighted average shares outstanding	77,137,683	85,622,216

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

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

(In Thousands)	Three Months	
(Unaudited)	Ended March 31,	
	2016	2015
Net Income	\$12,063	\$14,801
Other comprehensive income (loss):		
Net unrealized (loss) gain on available-for-sale securities	(10,103)	5,053
Reclassification of unrealized gain on available-for-sale securities to net income	(10,953)	(1,690)
Net unrealized loss on interest rate agreements	(14,243)	(8,442)
Reclassification of unrealized loss on interest rate agreements to net income	18	31
Total other comprehensive income (loss)	(35,281)	(5,048)
Total Comprehensive Income (Loss)	\$(23,218)	\$9,753

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Three Months Ended March 31, 2016

(In Thousands, Except Share Data) (Unaudited)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
	Shares	Amount					
December 31, 2015	78,162,765	\$ 782	\$ 1,695,956	\$ 91,993	\$ 1,018,683	\$(1,661,149)	\$ 1,146,265
Net income	—	—	—	—	12,063	—	12,063
Other comprehensive loss	—	—	—	(35,281)	—	—	(35,281)
Employee stock purchase and incentive plans	73,651	—	(152)	—	—	—	(152)
Non-cash equity award compensation	—	—	5,782	—	—	—	5,782
Share repurchases	(1,609,185)	(16)	(20,605)	—	—	—	(20,621)
Common dividends declared	—	—	—	—	—	(22,306)	(22,306)
March 31, 2016	76,627,231	\$ 766	\$ 1,680,981	\$ 56,712	\$ 1,030,746	\$(1,683,455)	\$ 1,085,750

For the Three Months Ended March 31, 2015

(In Thousands, Except Share Data) (Unaudited)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
	Shares	Amount					
December 31, 2014	83,443,141	\$ 834	\$ 1,774,030	\$ 140,688	\$ 906,867	\$(1,566,278)	\$ 1,256,141
Cumulative effect adjustment - adoption of ASU 2014-13 ⁽¹⁾	—	—	—	—	9,728	—	9,728
January 1, 2015	83,443,141	834	1,774,030	140,688	916,595	(1,566,278)	1,265,869
Net income	—	—	—	—	14,801	—	14,801
Other comprehensive loss	—	—	—	(5,048)	—	—	(5,048)
Dividend reinvestment & stock purchase plans	185,045	2	3,239	—	—	—	3,241
Employee stock purchase and incentive plans	120,435	1	(184)	—	—	—	(183)
Non-cash equity award compensation	—	—	2,692	—	—	—	2,692
Common dividends declared	—	—	—	—	—	(24,162)	(24,162)
March 31, 2015	83,748,621	\$ 837	\$ 1,779,777	\$ 135,640	\$ 931,396	\$(1,590,440)	\$ 1,257,210

On January 1, 2015, we adopted ASU 2014-13, "Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity," and recorded this cumulative-effect adjustment, which represents ⁽¹⁾ the net effect of adjusting the assets and liabilities of the consolidated Sequoia collateralized financing entities ("CFEs") from amortized historical cost to fair value.

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

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

(In Thousands) (Unaudited)	Three Months Ended March 31,	
	2016	2015
Cash Flows From Operating Activities:		
Net income	\$12,063	\$14,801
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(7,568)	(9,176)
Depreciation and amortization of non-financial assets	277	143
Purchases of held-for-sale loans	(1,245,068)	(2,558,425)
Proceeds from sales of held-for-sale loans	1,336,617	2,455,452
Principal payments on held-for-sale loans	23,518	14,394
Net settlements of derivatives	(1,154)	(19,373)
Provision for loan losses	289	206
Non-cash equity award compensation expense	5,782	2,692
Market valuation adjustments	15,848	19,435
Realized gains, net	(9,538)	(4,306)
Net change in:		
Accrued interest receivable and other assets	(30,056)	(38,394)
Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities	4,966	3,476
Net cash provided by (used in) operating activities	105,976	(119,075)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	—	(7,600)
Proceeds from sales of loans held-for-investment	6,298	—
Principal payments on loans held-for-investment	125,631	101,754
Purchases of real estate securities	(48,446)	(15,613)
Proceeds from sales of real estate securities	340,798	77,293
Principal payments on real estate securities	22,401	26,313
Purchase of mortgage servicing rights	(5,397)	(5,173)
Proceeds from sales of mortgage servicing rights	28,268	17,235
Net change in restricted cash	3,430	(97)
Net cash provided by investing activities	472,983	194,112
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	1,027,320	1,641,380
Repayments on short-term debt	(2,078,148)	(1,933,041)
Proceeds from issuance of asset-backed securities	—	420
Repayments on asset-backed securities issued	(50,868)	(80,918)
Deferred securities issuance costs	—	(32)
Proceeds from issuance of long-term debt	771,287	354,932
Repayments on long-term debt	(118,146)	—
Net settlements of derivatives	(73)	658
Net proceeds from issuance of common stock	77	134
Net payments on repurchase of common stock	(22,987)	—
Taxes paid on equity award distributions	(229)	(318)
Dividends paid	(22,306)	(24,162)
Net cash used in financing activities	(494,073)	(40,947)
Net increase in cash and cash equivalents	84,886	34,090
Cash and cash equivalents at beginning of period	220,229	269,730
Cash and cash equivalents at end of period	\$305,115	\$303,820

Supplemental Cash Flow Information:

Cash paid during the period for:

Interest	\$18,634	\$15,032
Taxes	64	38

Supplemental Noncash Information:

Real estate securities retained from loan securitizations	\$—	\$6,282
Retention of mortgage servicing rights from loan securitizations and sales	3,463	15,675
Transfers from loans held-for-sale to loans held-for-investment	660,818	447,840
Transfers from loans held-for-investment to loans held-for-sale	54,747	—
Transfers from residential loans to real estate owned	2,042	3,166

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

Note 1. Organization

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

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

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at March 31, 2016 and December 31, 2015, and for the three months ended March 31, 2016 and 2015. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with consolidated financial statements and notes thereto included in the company’s Annual Report on Form 10-K for the year ended December 31, 2015. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at March 31, 2016 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2016 should not be construed as indicative of the results to be expected for the full year.

In the second quarter of 2015, we began to specifically identify derivatives that are used to hedge our exposure to market interest rate risk associated with our mortgage servicing right (“MSR”) investments. As a result, beginning in the second quarter of 2015, we changed our income statement presentation to include the change in market value of these derivatives in the line item “Mortgage servicing rights income (loss), net.” As we previously managed our market interest rate risk on a portfolio-wide basis and did not necessarily rely on derivatives to hedge our MSRs, we cannot conform prior periods to the current presentation. Therefore, in periods prior to the second quarter of 2015 presented in our consolidated statements of income, amounts in “Mortgage servicing rights income (loss), net” do not reflect the impact of hedging. These changes and year-over-year comparisons are discussed in further detail in Part I, Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations in this Quarterly Report on Form 10-Q.

Additionally, in the first quarter of 2016, we began to present the changes in fair value of certain investments and their associated derivatives in the new line item "Investment fair value changes, net" on our consolidated statements of income and began to present income from mortgage banking activities in "Mortgage banking activities, net" on our consolidated statements of income. We conformed the presentation of prior periods related to this change for consistency of comparison. See Notes 18 and 19 for additional detail on the components of these income statement line items.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2016

(Unaudited)

Note 2. Basis of Presentation - (continued)

Principles of Consolidation

In accordance with GAAP, we determine whether we must consolidate transferred financial assets and variable interest entities (“VIEs”) for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a commercial securitization we engaged in during 2012 (“Commercial Securitization”). We also consolidated the assets and liabilities of an entity formed in connection with a resecuritization transaction we engaged in (“Residential Resecuritization”) from its creation in 2011 through the fourth quarter of 2015, when the debt of the entity was repaid, the assets of the entity were distributed to us, and the entity was dissolved. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

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

See Note 4 for further discussion on principles of consolidation.

Use of Estimates

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

Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies

Included in Note 3 to the Consolidated Financial Statements of our 2015 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company's consolidated financial condition and results of operations for the three months ended March 31, 2016.

Recent Accounting Pronouncements

Newly Adopted Accounting Standards Updates (“ASUs”)

In April 2015, the FASB issued ASU 2015-05, “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud-Computing Arrangement.” This new guidance provides additional guidance on accounting for fees paid in a cloud-computing arrangement that contains a software license. This new guidance is effective for fiscal years beginning after December 15, 2015. We adopted this guidance, as required, in the first quarter of 2016, which did not have a material impact on our consolidated financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

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

In April 2015, the FASB issued ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs." This new guidance requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount. This new guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years, and is required to be applied on a retrospective basis. We adopted this guidance, as required, in the first quarter of 2016 and now present our deferred securities issuance costs as a reduction to the related liabilities on our consolidated balance sheets for all periods presented. At March 31, 2016 and December 31, 2015, we included \$0.3 million and \$0.5 million, respectively, of deferred securities issuance costs as a reduction to our ABS issued and presented it as ABS issued, net on our consolidated balance sheets and, for both periods, we included \$10 million of deferred securities issuance costs as a reduction to our long-term debt and presented it as Long-term debt, net on our consolidated balance sheets. In February 2015, the FASB issued ASU 2015-02, "Consolidation (Topic 810) - Amendments to the Consolidation Analysis." This new guidance provides a new scope exception for certain money market funds, makes targeted amendments to the current consolidation guidance, and ends the deferral granted to investment companies from applying the VIE guidance. This new guidance is effective for annual periods beginning after December 15, 2015. We adopted this guidance, as required, in the first quarter of 2016, which did not have a material impact on our consolidated financial statements.

Other Recent Accounting Pronouncements

In March 2016, the FASB issued 2016 ASU 2016-09, "Compensation - Stock compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." This new guidance is to simplify the accounting for share-based payment transactions, including related income tax accounting, classification of awards, and classification on the statement of cash flows. This new guidance is effective for fiscal years beginning after December 15, 2016. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not believe it will have a material impact to our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases." This new guidance requires lessees to recognize most leases on their balance sheet as a right-of-use asset and a lease liability. This new guidance retains a dual lease accounting model, which requires leases to be classified as either operating or capital leases for lessees, for purposes of income statement recognition. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have on our consolidated financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

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

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." This new guidance amends accounting related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. This new guidance also amends certain disclosure requirements associated with the fair value of financial instruments and it is effective for fiscal years beginning after December 15, 2017. We are currently evaluating the impact that this update will have on our consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers." The update modifies the guidance companies use to recognize revenue from contracts with customers for transfers of goods or services and transfers of nonfinancial assets, unless those contracts are within the scope of other standards. The guidance also requires new qualitative and quantitative disclosures, including information about contract balances and performance obligations. In July 2015, the FASB approved a one year deferral of the effective date. Accordingly, the update is effective for us in the first quarter of 2018 with retrospective application to prior periods presented or as a cumulative effect adjustment in the period of adoption. Early adoption is permitted in the first quarter of 2017. In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)." This new guidance provides additional implementation guidance on how an entity should identify the unit of accounting for the principal versus agent evaluations. We are currently evaluating the impact these updates will have on our consolidated financial statements.

Balance Sheet Netting

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

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at March 31, 2016 and December 31, 2015.

Table 3.1 – Offsetting of Financial Assets, Liabilities, and Collateral

March 31, 2016 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet ⁽¹⁾		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
Assets ⁽²⁾						
Interest rate agreements	\$ 24,188	\$ —	—\$ 24,188	\$(18,926)	\$(4,581)	\$ 681
TBAs	2,843	—	2,843	(1,339)	—	1,504
Total Assets	\$ 27,031	\$ —	—\$ 27,031	\$(20,265)	\$(4,581)	\$ 2,185
Liabilities ⁽²⁾						
Interest rate agreements	\$(92,100)	\$ —	—\$(92,100)	\$ 18,926	\$ 73,174	\$ —
TBAs	(3,739)	—	(3,739)	1,339	1,680	(720)
Futures	(1,324)	—	(1,324)	—	1,324	—

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Loan warehouse debt	(368,679)	—	(368,679)	368,679	—	—
Security repurchase agreements	(435,496)	—	(435,496)	435,496	—	—
Total Liabilities	\$(901,338)	\$	—\$(901,338)	\$824,440	\$ 76,178	\$(720)

10

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

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

December 31, 2015 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet ⁽¹⁾ Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets ⁽²⁾						
Interest rate agreements	\$7,781	\$	—\$7,781	\$(5,651)	\$(1,917)	\$213
Credit default index swaps	1,207	—	1,207	—	(720)	487
TBAs	2,734	—	2,734	(1,898)	(293)	543
Total Assets	\$11,722	\$	—\$11,722	\$(7,549)	\$(2,930)	\$1,243
Liabilities ⁽²⁾						
Interest rate agreements	\$(58,366)	\$	—\$(58,366)	\$5,651	\$52,715	\$—
TBAs	(2,519)	—	(2,519)	1,898	7	(614)
Futures	(445)	—	(445)	—	445	—
Loan warehouse debt	(1,023,740)	—	(1,023,740)	1,023,740	—	—
Security repurchase agreements	(693,641)	—	(693,641)	693,641	—	—
Total Liabilities	\$(1,778,711)	\$	—\$(1,778,711)	\$1,724,930	\$53,167	\$(614)

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

Interest rate agreements, TBAs, and futures are components of derivatives instruments on our consolidated (2) balances sheets. Loan warehouse debt, which is secured by residential and commercial mortgage loans, and security repurchase agreements are components of Short-term debt on our consolidated balance sheets. For each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions within that category between us and a counterparty are subject to a master netting arrangement or similar agreement with that counterparty that provides for individual transactions to be aggregated and treated as a single transaction. For certain categories of these instruments, some of our transactions are cleared and settled through one or more clearinghouses that are substituted as our counterparty. References herein to master netting arrangements or similar agreements include the arrangements and agreements governing the clearing and settlement of these transactions through the clearinghouses. In the event of the termination and close-out of any of those transactions, the corresponding master netting agreement or similar agreement provides for settlement on a net basis. Any such settlement would include the proceeds of the liquidation of any corresponding collateral, subject to certain limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party. Such limitations should not inhibit the eventual practical realization of the principal benefits of those transactions or the corresponding master netting arrangement or similar agreement and any corresponding collateral.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 4. Principles of Consolidation

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

Analysis of Consolidated VIEs

As of March 31, 2016, the VIEs we are required to consolidate include certain Sequoia securitization entities and the Commercial Securitization entity. In addition, we consolidated the Residential Resecuritization from its creation in 2011 through the fourth quarter of 2015, when the VIE was dissolved. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

Table 4.1 – Assets and Liabilities of Consolidated VIEs

March 31, 2016 (Dollars in Thousands)	Sequoia Entities	Commercial Securitization	Total
Residential loans, held-for-investment	\$930,027	\$ —	\$930,027
Commercial loans, held-for-investment	—	164,626	164,626
Restricted cash	147	136	283
Accrued interest receivable	1,038	1,290	2,328
Other assets	4,884	47	4,931
Total Assets	\$936,096	\$ 166,099	\$1,102,195
Accrued interest payable	\$519	\$ 242	\$761
Asset-backed securities issued	907,023	51,680	958,703
Total Liabilities	\$907,542	\$ 51,922	\$959,464
Number of VIEs	20	1	21

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 4. Principles of Consolidation - (continued)

December 31, 2015 (Dollars in Thousands)	Sequoia Entities	Commercial Securitization	Total
Residential loans, held-for-investment	\$1,021,870	\$ —	\$1,021,870
Commercial loans, held-for-investment	—	166,016	166,016
Real estate securities	—	—	—
Restricted cash	228	137	365
Accrued interest receivable	1,131	1,297	2,428
Other assets	4,895	—	4,895
Total Assets	\$1,028,124	\$ 167,450	\$1,195,574
Accrued interest payable	\$555	\$ 249	\$804
Accrued expenses and other liabilities	100	—	100
Asset-backed securities issued, net	996,820	53,137	1,049,957
Total Liabilities	\$997,475	\$ 53,386	\$1,050,861

Number of VIEs 21 1 22

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 26 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes, in accordance with ASC 860. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSR's on our consolidated balance sheets, and classified those MSR's as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets. Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSR's (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.

The following table presents information related to securitization transactions that occurred during the three months ended March 31, 2016 and 2015.

Table 4.2 – Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended March 31, 2015
Principal balance of loans transferred	\$—338,796
Trading securities retained, at fair value	—3,423
AFS securities retained, at fair value	—2,859
MSR's recognized	—1,872

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 4. Principles of Consolidation - (continued)

The following table summarizes the cash flows during the three months ended March 31, 2016 and 2015 between us and the unconsolidated VIEs sponsored by us.

Table 4.3 – Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended March 31, 2016	2015
(In Thousands)		
Proceeds from new transfers	\$—	\$341,716
MSR fees received	3,523	3,770
Funding of compensating interest	(79)	(90)
Cash flows received on retained securities	11,112	11,645

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

Table 4.4 – Assumptions Related to Assets Retained from Unconsolidated VIEs Sponsored by Redwood

At Date of Securitization	Three Months Ended March 31, 2016		Three Months Ended March 31, 2015		
	MSRs	Subordinate Securities	MSRs	Subordinate Securities	
Prepayment rate	N/A	N/A	5% - 19%	8%	%
Discount rates	N/A	N/A	11%	6%	%
Credit loss assumptions	N/A	N/A	N/A	0.25%	%

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 4. Principles of Consolidation - (continued)

The following table presents additional information at March 31, 2016 and December 31, 2015, related to unconsolidated VIEs sponsored by Redwood and accounted for as sales since 2012.

Table 4.5 – Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	March 31, 2016	December 31, 2015
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	\$32,434	\$258,697
Senior and subordinate securities, classified as AFS	274,380	272,715
Mortgage servicing rights	39,220	56,984
Maximum loss exposure ⁽¹⁾	\$346,034	\$588,396
Assets transferred:		
Principal balance of loans outstanding	\$7,055,574	\$7,318,167
Principal balance of delinquent loans 30+ days delinquent	15,235	18,300

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

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at March 31, 2016 and December 31, 2015.

Table 4.6 – Key Assumptions and Sensitivity Analysis for Assets Retained from Unconsolidated VIEs Sponsored by Redwood

March 31, 2016	MSRs	Senior Securities (1)	Subordinate Securities
(Dollars in Thousands)			
Fair value at March 31, 2016	\$39,220	\$22,177	\$284,637
Expected life (in years) ⁽²⁾	4	4	11
Prepayment speed assumption (annual CPR) ⁽²⁾	21	% 14	% 13
Decrease in fair value from:			
10% adverse change	\$2,423	\$1,297	\$969
25% adverse change	5,800	3,039	2,459
Discount rate assumption ⁽²⁾	11	% 11	% 6
Decrease in fair value from:			
100 basis point increase	\$1,024	\$650	\$21,432
200 basis point increase	2,012	1,264	40,189
Credit loss assumption ⁽²⁾	N/A	0.25	% 0.25
Decrease in fair value from:			
10% higher losses	N/A	\$15	\$1,213
25% higher losses	N/A	38	3,042

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 4. Principles of Consolidation - (continued)

December 31, 2015 (Dollars in Thousands)	MSRs	Senior Securities (1)	Subordinate Securities
Fair value at December 31, 2015	\$56,984	\$248,570	\$282,842
Expected life (in years) (2)	7	5	12
Prepayment speed assumption (annual CPR) (2)	11	% 10	% 12
Decrease in fair value from:			
10% adverse change	\$2,868	\$2,042	\$901
25% adverse change	6,119	4,810	2,278
Discount rate assumption (2)	11	% 5	% 6
Decrease in fair value from:			
100 basis point increase	\$2,711	\$10,029	\$21,981
200 basis point increase	4,745	19,365	41,156
Credit loss assumption (2)	N/A	0.25	% 0.25
Decrease in fair value from:			
10% higher losses	N/A	\$35	\$1,244
25% higher losses	N/A	86	3,129

(1) Senior securities included \$22 million and \$31 million of interest only securities as of March 31, 2016 and December 31, 2015, respectively.

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

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at March 31, 2016, grouped by security type.

Table 4.7 – Third-Party Sponsored VIE Summary

(Dollars in Thousands)	March 31, 2016
Mortgage Backed Securities	
Senior	\$ 146,030
Re-REMIC	162,970
Subordinate	304,113
Total Investments in Third-Party Sponsored VIEs	\$613,113

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

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

material impact to our financial statements.

16

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

Note 5. Fair Value of Financial Instruments

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(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 March 31, 2016 and December 31, 2015.

Table 5.1 – Carrying Values and Fair Values of Assets and Liabilities

(In Thousands)	March 31, 2016		December 31, 2015	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	\$439,674	\$439,674	\$1,114,305	\$1,114,305
At lower of cost or fair value	1,402	1,594	1,433	1,635
Residential loans, held-for-investment ⁽¹⁾				
At fair value	3,273,980	3,273,980	2,813,065	2,813,065
Commercial loans, held-for-sale				
	—	—	39,141	39,141
Commercial loans, held-for-investment				
At fair value	69,674	69,674	67,657	67,657
At amortized cost	294,219	301,488	295,849	300,824
Trading securities	221,571	221,571	404,011	404,011
Available-for-sale securities	698,356	698,356	829,245	829,245
MSRs	126,620	126,620	191,976	191,976
Cash and cash equivalents	305,115	305,115	220,229	220,229
Restricted cash	2,137	2,137	5,567	5,567
Accrued interest receivable	19,766	19,766	23,290	23,290
Derivative assets	31,975	31,975	16,393	16,393
REO ⁽²⁾	4,884	5,475	4,896	5,282
Margin receivable ⁽²⁾	107,941	107,941	83,191	83,191
FHLBC stock ⁽²⁾	44,071	44,071	34,437	34,437
Guarantee asset ⁽²⁾	4,272	4,272	5,697	5,697
Pledged collateral ⁽²⁾	59,664	59,664	53,600	53,600
Liabilities				
Short-term debt				
	\$804,175	\$804,175	\$1,855,003	\$1,855,003
Accrued interest payable				
	15,522	15,522	8,936	8,936
Margin payable				
	14,247	14,247	6,415	6,415
Guarantee obligation				
	24,896	23,595	22,704	22,702
Derivative liabilities				
	97,468	97,468	62,794	62,794
ABS issued, net ^{(1) (2)}				
Fair value	907,023	907,023	996,820	996,820
Amortized cost	51,341	51,680	52,595	53,137
FHLBC long-term borrowings	1,999,999	1,999,999	1,343,023	1,343,023
Commercial secured borrowings	65,181	65,181	63,152	63,152
Convertible notes, net ⁽²⁾	479,798	453,396	483,119	461,053
Trust preferred securities and subordinated notes, net ⁽²⁾	138,454	80,910	138,443	83,700

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

(2) On January 1, 2016, we adopted ASU 2015-03 and began to present ABS issued, convertible notes, and other long-term debt net of deferred debt issuance costs. See Note 3 for further discussion.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

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

During the three months ended March 31, 2016, we elected the fair value option for \$48 million of residential subordinate securities, \$1.19 billion of residential loans (principal balance), \$38 million of commercial loans (principal balance), and \$9 million of MSRs. We anticipate electing the fair value option for all future purchases of residential loans that we intend to sell to third parties or transfer to securitizations as well as for MSRs purchased or retained from sales of residential loans.

The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at March 31, 2016 and December 31, 2015, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

Table 5.2 – Assets and Liabilities Measured at Fair Value on a Recurring Basis

March 31, 2016 (In Thousands)	Carrying Value	Fair Value Measurements		
		Using Level 1	Level 2	Level 3
Assets				
Residential loans	\$3,713,654	\$—	\$1,387	\$3,712,267
Commercial loans	69,674	—	—	69,674
Trading securities	221,571	—	—	221,571
Available-for-sale securities	698,356	—	—	698,356
Derivative assets	31,975	2,843	24,188	4,944
MSRs	126,620	—	—	126,620
Pledged collateral	59,664	59,664	—	—
FHLBC stock	44,071	—	44,071	—
Guarantee asset	4,272	—	—	4,272
Liabilities				
Derivative liabilities	\$97,468	\$5,063	\$92,100	\$305
Commercial secured borrowings	65,181	—	—	65,181
ABS issued	907,023	—	—	907,023
December 31, 2015				
(In Thousands)	Carrying Value	Fair Value Measurements		
		Using Level 1	Level 2	Level 3
Assets				
Residential loans	\$3,927,370	\$—	\$129,819	\$3,797,551
Commercial loans	106,798	—	—	106,798
Trading securities	404,011	—	—	404,011
Available-for-sale securities	829,245	—	—	829,245
Derivative assets	16,393	2,734	8,988	4,671
MSRs	191,976	—	—	191,976
Pledged collateral	53,600	53,600	—	—
FHLBC stock	34,437	—	34,437	—

Guarantee asset	5,697	—	—	5,697
Liabilities				
Derivative liabilities	\$62,794	\$2,963	\$58,368	\$1,463
Commercial secured borrowings	63,152	—	—	63,152
ABS issued	996,820	—	—	996,820

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

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

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the three months ended March 31, 2016.

Table 5.3 – Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis

(In Thousands)	Assets						Liabilities		
	Residential Loans	Commercial Loans	Trading Securities	AFS Securities	MSRs	Guarantee Asset	Derivatives	Commercial Secured Borrowings	ABS Issued
Beginning balance - December 31, 2015	\$3,797,551	\$106,798	\$404,011	\$829,245	\$191,976	\$5,697	\$3,208	\$63,152	\$996,820
Acquisitions	1,020,846	37,626	47,760	15,585	8,807	—	—	—	—
Sales	(941,790)	(77,183)	(220,123)	(125,911)	(29,559)	—	—	—	—
Principal paydowns	(161,241)	(171)	(5,718)	(16,683)	—	—	—	(155)	(49,411)
Gains (losses) in net income, net	(7,934)	2,604	(4,359)	17,314	(44,604)	(1,425)	15,606	2,171	(33,515)
Unrealized losses in OCI, net	—	—	—	(21,194)	—	—	—	—	—
Other settlements, net ⁽²⁾	4,835	—	—	—	—	—	(14,175)	13	(6,871)
Ending balance - March 31, 2016	\$3,712,267	\$69,674	\$221,571	\$698,356	\$126,620	\$4,272	\$4,639	\$65,181	\$907,023

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

(2) Other settlements, net for derivatives represents the transfer of the fair value of loan purchase commitments at the time loans are acquired to the basis of residential loans.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

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

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at March 31, 2016 and 2015. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three months ended March 31, 2016 and 2015 are not included in this presentation.

Table 5.4 – Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at March 31, 2016 and 2015 Included in Net Income

(In Thousands)	Included in Net Income Three Months Ended March 31,	
	2016	2015
Assets		
Residential loans at Redwood	\$27,285	\$5,464
Residential loans at consolidated Sequoia entities	(35,656)	1,179
Commercial loans	2,171	2,959
Trading securities	(6,135)	(13,790)
MSRs	(30,834)	(11,769)
Loan purchase commitments	4,644	7,422
Other assets - Guarantee asset	(1,425)	(1,083)
Liabilities		
Commercial secured borrowing	2,171	(1,509)
ABS issued	(33,515)	(2,946)

The following table presents information on assets recorded at fair value on a non-recurring basis at March 31, 2016. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our consolidated balance sheet at March 31, 2016.

Table 5.5 – Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at March 31, 2016

March 31, 2016	Carrying Value	Fair Value Measurements Using		Gain (Loss) for Three Months Ended March 31, 2016
		Level 1	Level 2 Level 3	
(In Thousands)				
Assets				
Residential loans, at lower of cost or fair value	\$ 1,076	\$ —	—\$ 1,076	\$ (16)
REO	1,285	—	— 1,285	(252)
Liabilities				
Guarantee obligation	\$ 928	\$ —	—\$ 928	\$ —

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

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

The following table presents the net gains and losses recorded in each line item of our consolidated statements of income for the three months ended March 31, 2016 and 2015.

Table 5.6 – Market Valuation Gains and Losses, Net

(In Thousands)	Three Months Ended	
	March 31, 2016	2015
Mortgage banking activities, net		
Residential loans held-for-sale, at fair value	\$5,439	\$2,056
Residential loan purchase and forward sale commitments	12,635	18,256
Commercial loans, at fair value ⁽¹⁾	433	5,857
Sequoia securities	1,484	(14,359)
Risk management derivatives, net	(12,754)	(10,583)
Total mortgage banking activities, net ⁽²⁾	\$7,237	\$1,227
Investment fair value changes, net		
Residential loans held-for-investment at Redwood	\$23,463	\$1,980
Net investments in consolidated Sequoia entities	(1,580)	(1,093)
Trading securities	(5,601)	270
Risk management derivatives, net	(35,810)	(1,374)
Risk sharing investments	(10)	(928)
Total investment fair value changes, net	\$(19,538)	\$(1,145)
MSR income (loss), net		
MSRs	\$(44,604)	\$(19,517)
Risk management derivatives, net	41,057	—
Total MSR loss, net ⁽³⁾	\$(3,547)	\$(19,517)
Total Market Valuation Losses, Net	\$(15,848)	\$(19,435)

Commercial loans at fair value does not include commercial A-notes, which were sold in 2014, but did not qualify (1) for sale treatment under GAAP. The market valuation gains and losses on the commercial A-notes and associated commercial secured borrowings net to zero in each period presented.

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

MSR income (loss), net presented above does not include net fee income or provisions for repurchases that are (3) components of MSR income (loss), net on our consolidated statements of income, as these amounts do not represent market valuation adjustments. In addition, we did not specifically identify derivatives used to hedge MSRs in the first quarter of 2015. See Note 2 for additional detail.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

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

At March 31, 2016, our valuation policy and processes had not changed from those described in our Annual Report on Form 10-K for the year ended December 31, 2015. The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

Table 5.7 – Fair Value Methodology for Level 3 Financial Instruments

March 31, 2016 (Dollars in Thousands, except Input Values)	Fair Value	Unobservable Input	Range		Weighted Average	
Assets						
Residential loans, at fair value:						
Jumbo fixed rate loans	\$2,494,912	Whole loan spread to TBA price	\$3.13	-\$4.35		\$4.12
Jumbo hybrid loans	83,124	Prepayment rate (annual CPR)	15	-15	%	15 %
		Spread to swap rate	130	-180	bps	151 bps
Jumbo loans committed to sell	204,204	Committed Sales Price	\$101.91	-\$102.30		\$102.14
Loans held by consolidated Sequoia entities ⁽¹⁾	930,027	Liability price		N/A		N/A
Residential loans, at lower of cost or fair value	1,076	Loss severity	15	-30	%	29 %
Commercial loans, at fair value	69,674	Spread to swap rate	212	-212	bps	212 bps
		Credit support	25	-25	%	25 %
Trading and AFS securities	919,927	Discount rate	5	-12	%	6 %
		Prepayment rate (annual CPR)	1	-35	%	14 %
		Default rate	—	-35	%	3 %
		Loss severity	20	-65	%	23 %
		Credit support	—	-48	%	4 %
MSRs	126,620	Discount rate	8	-13	%	10 %
		Prepayment rate (annual CPR)	4	-60	%	15 %
		Per loan annual cost to service	\$72	-\$82		\$78
Guarantee asset	4,272	Discount rate	11	-11	%	11 %
			19	-19	%	19 %

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			Prepayment rate (annual CPR)				
REO	1,285	Loss severity	11	-93	%	35	%
Loan purchase commitments, net ⁽²⁾	4,639	MSR Multiple	0.3	-6.6	x	2.8	x
		Fallout rate	2	-98	%	44	%
		Whole loan spread to TBA price	3.35	-4.35		4.16	
		Prepayment rate (annual CPR)	15	-15	%	15	%
		Spread to swap rate	130	-180	bps	154	bps
Liabilities							
ABS issued	907,023	Discount rate	5	-9	%	5	%
		Prepayment rate (annual CPR)	5	-20	%	12	%
		Default rate	1	-12	%	7	%
		Loss severity	20	-32	%	27	%
		Credit support	—	-33	%	9	%
Commercial secured borrowings	65,181	Spread to swap rate	212	-212	bps	212	bps
		Credit support	25	%-25	%	25	%

The fair value of the loans held by consolidated Sequoia entities was based on the fair value of the ABS issued by (1) these entities, which we determined were more readily observable, in accordance with accounting guidance for collateralized financing entities.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

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

Determination of Fair Value

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

Residential loans

Estimated fair values for residential loans are determined using models that incorporate various observable inputs, including pricing information from recent securitizations and whole loan sales. Certain significant inputs in these models are considered unobservable and are therefore Level 3 in nature. Pricing inputs obtained from market securitization activity include indicative spreads to indexed TBA prices for senior residential mortgage-backed securities ("RMBS") and indexed swap rates for subordinate RMBS (Level 3). Pricing inputs obtained from market whole loan transaction activity include indicative spreads to indexed to be announced ("TBA") prices for fixed-rate loans and indexed swap rates for hybrid loans (Level 3). Other observable inputs include benchmark interest rates, and prepayment rates. At March 31, 2016, our jumbo fixed-rate loans were priced exclusively using whole loan sale inputs. These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed, or credit support assumptions.

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

Commercial loans

Estimated fair values for senior commercial loans held-for-sale are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses include pricing points for current third-party commercial mortgage-backed securities ("CMBS") sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for the loans for purchase into securitization (Level 2). The estimated fair value of our senior commercial loans would generally decrease based upon an increase in credit spreads or required credit support. Estimated fair values for mezzanine commercial loans are determined by both market comparable pricing and discounted cash flow analysis valuation techniques (Level 3). Our discounted cash flow models utilize certain significant unobservable inputs including the underwritten net operating income and debt coverage ratio assumptions and actual performance relative to those underwritten metrics as well as estimated market discount rates. An increase in market discount rates would generally reduce the estimated fair value of the commercial loans.

Real estate securities

Real estate securities include residential, commercial, and other asset-backed securities that are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators that are factored into the analyses include bid/ask spreads, the amount and timing of credit losses, interest rates, and collateral

prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. The estimated fair value of our securities would generally decrease based upon an increase in default rates, serious delinquencies, or a decrease in prepayment rates or credit support.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

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

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at March 31, 2016, we received dealer price indications on 68% of our securities, representing 84% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were within 1% of the aggregate average dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Derivative assets and liabilities

Our derivative instruments include swaps, swaptions, TBAs, financial futures, CMBX credit default index swaps, loan purchase commitments ("LPCs"), and forward sale commitments ("FSCs"). Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets. Fair values of TBAs and financial futures are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2).

LPC fair values for conforming loans are estimated based on quoted Agency mortgage-backed securities ("MBS") prices, estimates of the fair value of the MSR we expect to retain in the sale of the loans, and the probability that the mortgage loan will be purchased (Level 3). FSC fair values for conforming loans are obtained using quoted Agency prices. LPC fair values for jumbo loans are estimated based on the estimated fair values of the underlying loans (as described in "Residential loans" above) as well as the probability that the mortgage loan will be purchased (Level 3). For other derivatives, valuations are based on various factors such as liquidity, bid/ask spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management's best estimate is used (Level 3).

MSRs

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

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

FHLBC Stock

Our Federal Home Loan Bank ("FHLB") member subsidiary is required to purchase Federal Home Loan Bank of Chicago ("FHLBC") stock under a borrowing agreement between our FHLB-member subsidiary and the FHLBC. Under this agreement, the stock is redeemable at face value, which represents the carrying value and fair value of the stock (Level 2).

Guarantee Asset

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

25

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2016
(Unaudited)

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

Pledged Collateral

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

(Level 1).

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

REO

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

Margin receivable

Margin receivable reflects cash collateral we have posted with our various derivative and debt counterparties as required to satisfy margin requirements. Fair values approximate carrying values (Level 2).

Guarantee Obligations

In association with our risk sharing transactions with the Agencies, we have made certain guarantees. For these transactions, at the close of each delivery period, or at quarter-end for open delivery periods, we recognize a liability representing the fair value of the guarantee obligations we assumed. Fair values of guarantee obligations are determined using internal models that incorporate certain significant inputs that are considered unobservable and are therefore Level 3 in nature. Pricing inputs include prepayment assumptions, loss assumptions, and discount rates. An increase in discount rates or loss rates, or a decrease in prepayment rates, would reduce the estimated fair value of the guarantee obligations.

Short-term debt

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

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

ABS issued

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

FHLBC Borrowings

FHLBC borrowings include amounts borrowed from the FHLBC that are secured, generally by residential mortgage loans. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 2).

Commercial secured borrowings

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

Convertible notes

Convertible notes include unsecured convertible and exchangeable senior notes. Fair values are determined using quoted prices in active markets (Level 2).

Trust preferred securities and subordinated notes

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

Note 6. Residential Loans

We acquire residential loans from third-party originators. The following table summarizes the classifications and carrying values of the residential loans owned at Redwood and at consolidated Sequoia entities at March 31, 2016 and December 31, 2015.

Table 6.1 – Classifications and Carrying Values of the Residential Loans

March 31, 2016

(In Thousands)	Redwood	Sequoia	Total
Held-for-sale			
Fair value - conforming	\$1,387	\$—	\$1,387
Fair value - jumbo	438,287	—	438,287
Lower of cost or fair value - jumbo	1,402	—	1,402
Total held-for-sale	441,076	—	441,076
Held-for-investment			
Fair value - jumbo	2,343,953	930,027	3,273,980
Total Residential Loans	\$2,785,029	\$930,027	\$3,715,056

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 6. Residential Loans - (continued)

December 31, 2015 (In Thousands)	Redwood	Sequoia	Total
Held-for-sale			
Fair value - conforming	\$129,819	\$—	\$129,819
Fair value - jumbo	984,486	—	984,486
Lower of cost or fair value - jumbo	1,433	—	1,433
Total held-for-sale	1,115,738	—	1,115,738
Held-for-investment			
Fair value - jumbo	1,791,195	1,021,870	2,813,065
Total Residential Loans	\$2,906,933	\$1,021,870	\$3,928,803

At March 31, 2016, we owned mortgage servicing rights associated with \$1.88 billion (principal balance) of consolidated residential loans purchased from third-party originators. The value of these MSR's is included in the carrying value of the associated loans on our consolidated balance sheet. We contract with licensed sub-servicers that perform servicing functions for these loans.

Residential Loans Held-for-Sale

At Fair Value

At March 31, 2016, we owned 588 loans held-for-sale at fair value with an aggregate unpaid principal balance of \$429 million and a fair value of \$440 million, compared to 1,763 loans with an aggregate unpaid principal balance of \$1.09 billion and a fair value of \$1.11 billion at December 31, 2015. At March 31, 2016, none of these loans were greater than 90 days delinquent or in foreclosure. At December 31, 2015, two of these loans were greater than 90 days delinquent and one of these loans was in foreclosure.

During the three months ended March 31, 2016 and 2015, we purchased \$1.19 billion and \$2.40 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold \$1.24 billion and \$2.20 billion (principal balance) of loans, respectively, for which we recorded net market valuation gains of \$5 million and \$2 million, respectively, through Mortgage banking activities, net, a component of our consolidated statements of income. At March 31, 2016, loans held-for-sale with a market value of \$414 million were pledged as collateral under short-term borrowing agreements.

At Lower of Cost or Fair Value

At March 31, 2016 and December 31, 2015, we held nine residential loans at the lower of cost or fair value with \$2 million in outstanding principal balance and a carrying value of \$1 million for both periods. At both March 31, 2016 and December 31, 2015, two of these loans were greater than 90 days delinquent and one of these loans was in foreclosure.

Residential Loans Held-for-Investment at Fair Value

At Redwood

At March 31, 2016, we owned 3,096 held-for-investment loans at Redwood with an aggregate unpaid principal balance of \$2.28 billion and a fair value of \$2.34 billion, compared to 2,398 loans with an aggregate unpaid principal balance of \$1.76 billion and a fair value of \$1.79 billion at December 31, 2015. At both March 31, 2016 and December 31, 2015, none of these loans were greater than 90 days delinquent or in foreclosure.

During the three months ended March 31, 2016 and 2015, we transferred loans with a fair value of \$660 million and \$448 million, respectively, from held-for-sale to held-for-investment. During the three months ended March 31, 2016, we transferred loans with a fair value of \$54 million from held-for-investments to held-for-sale. We did not transfer loans from held-for-investment to held-for-sale during the three months ended March 31, 2015.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 6. Residential Loans - (continued)

During the three months ended March 31, 2016 and 2015, we recorded net market valuation gains of \$23 million and \$2 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net, a component of our consolidated statements of income. At March 31, 2016, \$2.34 billion of these loans were pledged as collateral under a borrowing agreement with the FHLBC.

The outstanding loans held-for-investment at Redwood at March 31, 2016 were prime-quality, first lien loans, of which 93% were originated between 2013 and 2016, and 7% were originated in 2012 and prior years. The weighted average FICO score of borrowers backing these loans was 772 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 66% (at origination). At March 31, 2016, these loans were comprised of 99% fixed-rate loans with a weighted average coupon of 4.16%, and the remainder were hybrid or ARM loans with a weighted average coupon of 4.00%.

At Consolidated Sequoia Entities

At March 31, 2016, we owned 4,221 held-for-investment loans at consolidated Sequoia entities, with an aggregate unpaid principal balance of \$1.06 billion and a fair value of \$930 million, as compared to 4,545 loans at December 31, 2015, with an aggregate unpaid principal balance of \$1.12 billion and a fair value of \$1.02 billion. At origination, the weighted average FICO score of borrowers backing these loans was 729, the weighted average LTV ratio of these loans was 66%, and the loans were nearly all first lien and prime-quality. At March 31, 2016 and December 31, 2015, the unpaid principal balance of loans at consolidated Sequoia entities delinquent greater than 90 days was \$51 million and \$59 million, respectively, and the unpaid principal balance of loans in foreclosure was \$26 million and \$32 million, respectively. During the three months ended March 31, 2016 and 2015, we recorded net market valuation losses of \$36 million and net market valuation gains of \$3 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income.

Note 7. Commercial Loans

We invest in commercial loans that we historically originated or acquired. In February 2016, we discontinued commercial loan originations. The following table summarizes the classifications and carrying value of commercial loans at March 31, 2016 and December 31, 2015.

Table 7.1 – Classifications and Carrying Value of Commercial Loans

(In Thousands)	March 31, December 31,	
	2016	2015
Held-for-sale, at fair value	\$—	\$ 39,141
Held-for-investment		
At fair value	69,674	67,657
At amortized cost	294,219	295,849
Total Commercial Loans	\$ 363,893	\$ 402,647

Of the held-for-investment commercial loans at amortized cost shown above at March 31, 2016 and December 31, 2015, \$165 million and \$166 million, respectively, were financed through the Commercial Securitization entity, and \$7 million and \$135 million, respectively, were pledged as collateral under short-term borrowing arrangements.

Commercial Loans Held-for-Sale at Fair Value

Commercial loans held-for-sale include loans we originated with the intent to sell to third parties. At March 31, 2016, we did not hold any senior commercial mortgage loans. As of December 31, 2015, there were four senior commercial mortgage loans at fair value, with an aggregate outstanding principal balance of \$39 million and an aggregate fair value of \$39 million.

During the three months ended March 31, 2016 and 2015, we acquired \$38 million and \$93 million (principal balance), respectively, of senior commercial loans for which we elected the fair value option and sold \$76 million and

\$203 million (principal balance), respectively, of loans to third parties. During the three months ended March 31, 2016 and 2015, we recorded \$0.4 million and \$6 million, respectively, of net market valuation gains on senior commercial mortgage loans for which we elected the fair value option through Mortgage banking activities, net on our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2016

(Unaudited)

Note 7. Commercial Loans - (continued)

Commercial Loans Held-for-Investment

At Fair Value

Commercial loans held-for-investment at fair value include senior mortgage loans for which we have elected the fair value option and have been split into senior A-notes and junior B-notes. Although the A-notes for each of the loans were sold, the transfers did not qualify for sale accounting treatment and we treated the sales as secured borrowings. At March 31, 2016 and December 31, 2015, we held three of these A/B notes with an aggregate outstanding principal balance of \$67 million and \$67 million, respectively, and an aggregate fair value of \$70 million and \$68 million, respectively. We carry the A-notes and associated secured commercial borrowings at the same fair values and the periodic valuation adjustments associated with these assets and liabilities completely offset through our consolidated statements of income. During the three months ended March 31, 2016 and 2015, there were no net changes in the fair value of the B-notes, in which we retain an actual economic interest. The carrying value of the B-notes at March 31, 2016 and December 31, 2015 was \$4 million and \$5 million, respectively.

At Amortized Cost

Commercial loans held-for-investment primarily include mezzanine loans that are secured by a borrower's ownership interest in a single purpose entity that owns commercial property. The following table provides additional information for our commercial loans held-for-investment at amortized cost at March 31, 2016 and December 31, 2015.

Table 7.2 – Carrying Value for Commercial Loans Held-for-Investment at Amortized Cost

(In Thousands)	March 31, December 31,	
	2016	2015
Principal balance	\$305,517	\$ 307,047
Unamortized discount, net	(3,908)	(4,096)
Recorded investment	301,609	302,951
Allowance for loan losses	(7,390)	(7,102)
Carrying Value	\$294,219	\$ 295,849

At March 31, 2016 and December 31, 2015, we held 58 and 59, respectively, commercial loans held-for-investment at amortized cost. Of the \$302 million of recorded investment in commercial loans held-for-investment at March 31, 2016, 7% was originated in 2015, 19% was originated in 2014, 16% was originated in 2013, 31% was originated in 2012, 23% was originated in 2011, and 4% was originated in 2010.

Allowance for Loan Losses on Commercial Loans

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

Our methodology for assessing the adequacy of the allowance for loan losses includes a formal review of each commercial loan in the portfolio and the assignment of an internal impairment status. Based on the assigned impairment status, a loan is categorized as "Pass," "Watch List," or "Workout."

The following table presents the principal balance of commercial loans held-for-investment by risk category.

Table 7.3 – Principal Balance of Commercial Loans Held-for-Investment by Risk Category

(In Thousands)	March 31, December 31,	
	2016	2015
Pass	\$260,599	\$ 272,768
Watch list	44,918	34,279
Total Commercial Loans Held-for-Investment	\$305,517	\$ 307,047

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2016

(Unaudited)

Note 7. Commercial Loans - (continued)

The following table summarizes the activity in the allowance for commercial loan losses for the three months ended March 31, 2016 and 2015.

Table 7.4 – Activity in the Allowance for Commercial Loan Losses

(In Thousands)	Three Months Ended March 31,	
	2016	2015
Balance at beginning of period	\$7,102	\$7,457
Provision for loan losses	288	205
Balance at End of Period	\$7,390	\$7,662

At March 31, 2016 and December 31, 2015, all of our commercial loans collectively evaluated for impairment were current. We did not have any commercial loans individually evaluated for impairment at either March 31, 2016 or December 31, 2015. The following table summarizes the balances for loans collectively evaluated for impairment at March 31, 2016 and December 31, 2015.

Table 7.5 – Loans Collectively Evaluated for Impairment Review

(In Thousands)	March 31, December 31,	
	2016	2015
Principal balance	\$305,517	\$307,047
Recorded investment	301,609	302,951
Related allowance	7,390	7,102

Note 8. Real Estate Securities

We invest in real estate securities. The following table presents the fair values of our real estate securities by type at March 31, 2016 and December 31, 2015.

Table 8.1 – Fair Values of Real Estate Securities by Type

(In Thousands)	March 31, December 31,	
	2016	2015
Trading	\$221,571	\$404,011
Available-for-sale	698,356	829,245
Total Real Estate Securities	\$919,927	\$1,233,256

Our real estate securities include RMBS and CMBS, which are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior security interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior security interests, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests. In addition, our real estate securities include investments in Agency residential mortgage credit risk transfer (or "CRT") securities, which are presented as subordinate securities.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 8. Real Estate Securities - (continued)

Trading Securities

The following table presents the fair value of trading securities by collateral type at March 31, 2016 and December 31, 2015.

Table 8.2 – Trading Securities by Collateral Type

(In Thousands)	March 31, December 31,	
	2016	2015
Senior Securities		
Prime	\$ 22,177	\$ 248,570
Non-prime	5,414	5,781
Total Senior Securities	27,591	254,351
Subordinate Securities		
Prime mezzanine ⁽¹⁾	144,317	136,140
Prime subordinate ⁽²⁾	49,663	13,520
Total Subordinate Securities ⁽³⁾	193,980	149,660
Total Trading Securities	\$ 221,571	\$ 404,011

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

(2) Subordinate securities includes less than \$1 million of non-prime securities at both March 31, 2016, and December 31, 2015.

(3) At March 31, 2016, and December 31, 2015, subordinate securities included \$62 million and \$25 million, respectively, of CRT securities.

We elected the fair value option for certain securities and classify them as trading securities. At March 31, 2016 and December 31, 2015, our senior trading securities included \$28 million and \$37 million, respectively, of interest-only securities, for which there is no principal balance, and the remaining unpaid principal balance of our senior trading securities was zero and \$217 million, respectively, and the unpaid principal balance of our subordinate trading securities was \$212 million and \$168 million, respectively.

During the three months ended March 31, 2016 and 2015, we acquired \$50 million and \$23 million (principal balance), respectively, of senior and subordinate securities for which we elected the fair value option and classified as trading, and sold \$218 million and \$3 million, respectively, of such securities. During the three months ended March 31, 2016 and 2015, we recorded net market valuation losses of \$4 million and \$14 million, respectively, on trading securities, included in Investment fair value changes, net and Mortgage banking activities, net on our consolidated statements of income. As of March 31, 2016, trading securities with a carrying value of \$142 million were pledged as collateral under short-term borrowing agreements. See Note 12 for additional information on short-term debt.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 8. Real Estate Securities - (continued)

AFS Securities

The following table presents the fair value of our available-for-sale securities by collateral type at March 31, 2016 and December 31, 2015.

Table 8.3 – Available-for-Sale Securities by Collateral Type

(In Thousands)	March 31, December 31,	
	2016	2015
Senior Securities		
Prime	\$ 111,523	\$ 210,993
Non-prime	29,093	68,258
Total Senior Securities	140,616	279,251
Re-REMIC Securities	162,970	165,064
Subordinate Securities		
Prime mezzanine ⁽¹⁾	225,787	224,624
Prime subordinate ⁽²⁾	168,983	160,306
Total Subordinate Securities	394,770	384,930
Total AFS Securities	\$ 698,356	\$ 829,245

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

(2) Subordinate securities includes less than \$1 million of non-prime securities at both March 31, 2016, and December 31, 2015.

As of March 31, 2016, AFS securities with a carrying value of \$389 million were pledged as collateral under short-term borrowing agreements. See Note 12 for additional information on short-term debt.

During the three months ended March 31, 2016 and 2015, we purchased \$16 million and \$10 million of AFS securities, respectively, and sold \$126 million and \$91 million of AFS securities, respectively, which resulted in net realized gains of \$9 million and \$4 million, respectively.

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

At March 31, 2016, there were \$2 million of AFS securities with contractual maturities less than five years, none with contractual maturities greater than five years but less than 10 years, and the remainder of our AFS securities had contractual maturities greater than 10 years.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2016
 (Unaudited)

Note 8. Real Estate Securities - (continued)

The following table presents the components of carrying value (which equals fair value) of AFS securities at March 31, 2016 and December 31, 2015.

Table 8.4 – Carrying Value of AFS Securities

March 31, 2016	Senior				
(In Thousands)	Prime	Non-prime	Re-REMIC	Subordinate	Total
Principal balance	\$ 120,577	\$ 31,781	\$ 189,146	\$ 504,228	\$ 845,732
Credit reserve	(1,108)	(687)	(11,258)	(35,494)	(48,547)
Unamortized discount, net	(13,491)	(3,262)	(66,586)	(136,291)	(219,630)
Amortized cost	105,978	27,832	111,302	332,443	577,555
Gross unrealized gains	9,326	1,482	51,668	64,538	127,014
Gross unrealized losses	(3,781)	(221)	—	(2,211)	(6,213)
Carrying Value	\$ 111,523	\$ 29,093	\$ 162,970	\$ 394,770	\$ 698,356
December 31, 2015	Senior				
(In Thousands)	Prime	Non-prime	Re-REMIC	Subordinate	Total
Principal balance	\$ 217,605	\$ 75,591	\$		