

REDWOOD TRUST INC
Form 10-Q
May 07, 2015
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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, 2015

OR

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

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

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland

(State or Other Jurisdiction of
Incorporation or Organization)

68-0329422

(I.R.S. Employer
Identification No.)

One Belvedere Place, Suite 300

Mill Valley, California

(Address of Principal Executive Offices)

94941

(Zip Code)

(415) 389-7373

(Registrant's Telephone Number, Including Area Code)

Not Applicable

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

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

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

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

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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

Common Stock, \$0.01 par value per share

84,257,726 shares outstanding as of May 4, 2015

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)

(Unaudited)	March 31, 2015	December 31, 2014
ASSETS ⁽¹⁾		
Residential loans, held-for-sale, at fair value	\$ 1,094,885	\$ 1,342,519
Residential loans, held-for-investment, at fair value ⁽²⁾	2,304,870	2,056,054
Commercial loans, held-for-sale, at fair value	54,407	166,234
Commercial loans, held-for-investment (includes \$72,619 and \$71,262 at fair value)	405,935	400,693
Real estate securities, at fair value	1,285,243	1,379,230
Mortgage servicing rights, at fair value	120,324	139,293
Cash and cash equivalents	303,820	269,730
Total earning assets	5,569,484	5,753,753
Restricted cash	725	628
Accrued interest receivable	17,970	18,222
Derivative assets	30,546	16,417
Deferred securities issuance costs	14,302	16,050
Other assets	182,992	113,896
Total Assets	\$ 5,816,019	\$ 5,918,966
LIABILITIES AND EQUITY ⁽¹⁾		
Liabilities		
Short-term debt	\$ 1,502,164	\$ 1,793,825
Accrued interest payable	14,319	8,503
Derivative liabilities	68,064	58,331
Accrued expenses and other liabilities	60,135	52,244
Deferred tax liability	10,237	10,236
Asset-backed securities issued (includes \$1,239,065 and \$0 at fair value) ⁽²⁾	1,353,021	1,545,119
Long-term debt (includes \$68,707 and \$66,707 at fair value)	1,550,869	1,194,567
Total liabilities	4,558,809	4,662,825
Equity		
Common stock, par value \$0.01 per share, 180,000,000 shares authorized; 83,748,621 and 83,443,141 issued and outstanding	837	834
Additional paid-in capital	1,779,777	1,774,030
Accumulated other comprehensive income	135,640	140,688
Cumulative earnings	931,396	906,867
Cumulative distributions to stockholders	(1,590,440)	(1,566,278)
Total equity	1,257,210	1,256,141
Total Liabilities and Equity	\$ 5,816,019	\$ 5,918,966

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 the primary beneficiary (Redwood Trust, Inc.). At March 31, 2015 and December 31, 2014, assets of consolidated VIEs totaled \$1,716,563 and \$1,900,208, respectively, and liabilities of consolidated VIEs totaled \$1,354,298 and \$1,546,490, respectively. See Note 4 for further discussion.

On January 1, 2015, we adopted ASU 2014-13 and began to account for residential loans held-for-investment and asset backed securities issued at consolidated Sequoia entities (which are VIEs) at fair value. At December 31, (2) 2014, amounts presented in residential loans held-for-investment for these assets included \$1,474,386 at historical cost. See Note 3 for further discussion.

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

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CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data)		Three Months Ended March 31,	
(Unaudited)		2015	2014
Interest Income			
Residential loans		\$25,009	\$12,658
Commercial loans		10,914	10,384
Real estate securities		27,775	32,431
Cash and cash equivalents		48	3
Total interest income		63,746	55,476
Interest Expense			
Short-term debt		(7,224	) (3,827
Asset-backed securities issued		(6,202	) (8,441
Long-term debt		(10,535	) (6,792
Total interest expense		(23,961	) (19,060
Net Interest Income		39,785	36,416
Provision for loan losses		(206	) (1,284
Net Interest Income After Provision		39,579	35,132
Non-interest Income			
Mortgage banking activities		1,923	(231
Mortgage servicing rights income (loss)		(10,924	) 606
Other market valuation adjustments ⁽¹⁾		(1,145	) (6,138
Realized gains, net		4,306	1,092
Other income		809	—
Total non-interest income (loss)		(5,031	) (4,671
Operating expenses		(25,063	) (19,971
Net income before provision for income taxes		9,485	10,490
Benefit from income taxes		5,316	1,843
Net Income		\$14,801	\$12,333
Basic earnings per common share		\$0.17	\$0.14
Diluted earnings per common share		\$0.16	\$0.14
Regular dividends declared per common share		\$0.28	\$0.28
Basic weighted average shares outstanding		83,360,312	82,410,562
Diluted weighted average shares outstanding		85,622,216	84,940,540

For the three months ended March 31, 2015, there were no other-than-temporary impairments. For the three (1) months ended March 31, 2014, other-than-temporary impairments were \$1,671, of which \$113 were recognized through the Income Statement and \$1,558 were recognized in Accumulated Other Comprehensive Income.

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

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

(In Thousands)	Three Months Ended	
	March 31, 2015	
(Unaudited)	2015	2014
Net Income	\$14,801	\$12,333
Other comprehensive income:		
Net unrealized gain on available-for-sale securities	5,053	19,323
Reclassification of unrealized (gain) loss on available-for-sale securities to net income	(1,690)	) 1,298
Net unrealized (loss) gain on interest rate agreements	(8,442)	) (8,795)
Reclassification of unrealized loss on interest rate agreements to net income	31	60
Total other comprehensive (loss) income	(5,048)	) 11,886
Total Comprehensive Income	\$9,753	\$24,219

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

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CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

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)
Issuance of common stock: 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

For the Three Months Ended March 31, 2014

(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, 2013	82,504,801	\$825	\$1,760,899	\$148,766	\$806,298	\$(1,471,005)	) \$1,245,783
Net income	—	—	—	—	12,333	—	12,333
Other comprehensive income	—	—	—	11,886	—	—	11,886
Issuance of common stock: Dividend reinvestment & stock purchase	77,660	1	1,544	—	—	—	1,545

plans									
Employee stock									
purchase and	37,193	—	(783	)	—	—	(783)	
incentive plans									
Non-cash equity									
award	—	—	3,872	—	—	—	3,872		
compensation									
Common dividends									
declared	—	—	—	—	—	(23,749)	(23,749)
March 31, 2014	82,619,654	\$826	\$1,765,532	\$160,652	\$818,631	\$(1,494,754)	\$1,250,887	
(1) On January 1, 2015, we adopted ASU 2014-13. See Note 3 for further discussion.									

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) (Unaudited)	Three Months Ended March 31,	
	2015	2014
Cash Flows From Operating Activities:		
Net income	\$ 14,801	\$ 12,333
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(9,176	) (9,158
Depreciation and amortization of non-financial assets	143	106
Purchases of held-for-sale loans	(2,558,425	) (1,181,488
Proceeds from sales of held-for-sale loans	2,455,452	785,380
Principal payments on held-for-sale loans	14,394	7,014
Net settlements of derivatives	(19,373	) (8,394
Provision for loan losses	206	1,284
Non-cash equity award compensation expense	2,692	3,872
Market valuation adjustments	19,435	9,446
Realized gains, net	(4,306	) (1,092
Net change in:		
Accrued interest receivable and other assets	(38,394	) (7,279
Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities	3,476	(13,682
Net cash used in operating activities	(119,075	) (401,658
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(7,600	) (32,998
Principal payments on loans held-for-investment	101,754	70,800
Purchases of real estate securities	(15,613	) (49,709
Proceeds from sales of real estate securities	77,293	—
Principal payments on real estate securities	26,313	42,304
Purchase of mortgage servicing rights	(5,173	) (928
Proceeds from sales of mortgage servicing rights	17,235	—
Net increase in restricted cash	(97	) (34
Net cash provided by investing activities	194,112	29,435
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	1,641,380	920,955
Repayments on short-term debt	(1,933,041	) (494,956
Proceeds from issuance of asset-backed securities	420	—
Repayments on asset-backed securities issued	(80,918	) (88,523
Deferred securities issuance costs	(32) —
Proceeds from issuance of long-term debt	354,932	36,782
Repayments on long-term debt	—	(17
Net settlements of derivatives	658	(721
Net proceeds from issuance of common stock	134	122
Taxes paid on equity award distributions	(318	) (905
Dividends paid	(24,162	) (23,749
Net cash (used in) provided by financing activities	(40,947	) 348,988
Net increase (decrease) in cash and cash equivalents	34,090	(23,235
Cash and cash equivalents at beginning of period	269,730	173,201
Cash and cash equivalents at end of period	\$ 303,820	\$ 149,966
Supplemental Cash Flow Information:		

Cash paid during the period for:

Interest	\$ 15,032	\$ 15,386
Taxes	38	1,399

Supplemental Noncash Information:

Real estate securities retained from loan securitizations	\$ 6,282	\$ —
Retention of mortgage servicing rights from loan securitizations and sales	15,675	2,294
Transfers from loans held-for-sale to loans held-for-investment	447,840	37,631
Transfers from residential loans to real estate owned	3,166	135

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2015
(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 residential and commercial mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential and commercial mortgage banking activities. We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. 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. To qualify as a REIT, we must distribute at least 90% of our annual REIT taxable income to shareholders (not including taxable income retained in our taxable subsidiaries) within the time frame set forth in the tax code and also meet certain other requirements related to assets, income, and stock ownership. We 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 generally intend to distribute as dividends at least 90% of the taxable income we generate at our REIT.

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at March 31, 2015 and December 31, 2014, and for the three months ended March 31, 2015 and 2014. 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, 2014. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at March 31, 2015 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2015 should not be construed as indicative of the results to be expected for the full year.

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 rescuritization transaction we engaged in during 2011 (“Residential Resecuritization”), and an entity formed in connection with a commercial securitization we engaged in during 2012 (“Commercial Securitization”). Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and

are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, 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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 2. Basis of Presentation - (continued)

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.

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 2014 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, 2015.

Recent Accounting Pronouncements

Adoption of ASU 2014-13

In November 2014, the FASB issued ASU 2014-13, "Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity" (ASU 2014-13). This update provides a measurement alternative to companies that consolidate collateralized financing entities ("CFEs"). Under the new guidance, companies can measure both the financial assets and financial liabilities of a CFE using the more observable of the fair value of the financial assets or fair value of the financial liabilities. This guidance is effective in the first quarter 2016 with early adoption permitted at the beginning of an annual period. The guidance can be applied either retrospectively to all relevant prior periods or by a modified retrospective approach with a cumulative-effect adjustment to equity as of the beginning of the annual period of adoption.

On January 1, 2015, we elected to early adopt ASU 2014-13, as we determined this measurement alternative more accurately reflects our economic interests in, and financial results from, certain consolidated financing entities. We adopted the measurement alternative under this standard only for our consolidated Sequoia entities, which qualify under the standard as CFEs. We did not elect the measurement alternative for our Residential Resecuritization or our Commercial Resecuritization, and will continue to account for the assets and liabilities in these CFEs in accordance with existing accounting guidance.

Under the provisions of ASU 2014-13, we use the fair value of the liabilities issued by the Sequoia CFEs (which we determined to be more observable) to determine the fair value of the assets, whereby the net assets we consolidate in our financial statements related to these entities represents the estimated fair value of our retained interests in the Sequoia CFEs. Similarly, the periodic net market valuation adjustments we record on our income statement from the consolidated assets and liabilities of the CFEs represents the change in fair value of our retained interests in the Sequoia CFEs.

Using the modified retrospective approach, we recorded a cumulative-effect adjustment to equity of \$10 million through retained earnings as of January 1, 2015. This cumulative-effect adjustment represents the net effect of adjusting the assets and liabilities of the Sequoia CFEs from amortized historical cost to fair value.

Subsequent to the adoption of ASU 2014-13, the consolidated assets and liabilities of the Sequoia CFEs are both carried at fair value, with the periodic net changes in fair value recorded on our income statement, in Other market valuation adjustments.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

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

The following table presents the assets and liabilities of the consolidated Sequoia entities at December 31, 2014 prior to the adoption of ASU 2014-13, the adjustments required to adopt the new standard, and the adjusted balances at January 1, 2015.

Impact of Adoption of ASU 2014-13 on Balance Sheet ⁽¹⁾

(In Millions)	December 31, 2014	ASU 2014-13 Adjustment	January 1, 2015
Loan Principal	\$ 1,486	\$(113)	) \$ 1,373
Loan unamortized premium	13	(13)) —
Allowance for loan losses	(21)	) 21	—
Residential loans held-for-investment	1,478	(105)	) 1,373
Deferred bond issuance costs	1	(1)) —
Other assets	5	—	5
Total assets	1,482	(105)	) 1,377
ABS issued principal	1,428	(125)	) 1,303
ABS issued unamortized discount	(10)	) 10	—
Total liabilities	1,418	(115)	) 1,303
Redwood's investment in consolidated Sequoia entities	\$ 64	\$ 10	\$ 74

(1) Certain totals may not foot due to rounding.

Other Recent Accounting Pronouncements

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. Early adoption is permitted for financial statements that have not been previously issued. The new guidance is required to be applied on a retrospective basis. We plan to adopt this new guidance by the required date and will reclassify debt issuance costs that we currently present in other assets on our consolidated balance sheets and present them as debt discounts.

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, 2016. Early adoption is allowed, including in any interim period. We are currently evaluating the impact of adopting this new standard.

In June 2014, the FASB issued ASU 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures." This new guidance amends the accounting guidance for "repo-to-maturity" transactions and repurchase agreements executed as repurchase financings. In addition, the new standard requires a transferor to disclose more information about certain transactions, including those in which it retains substantially all of the exposure to the economic returns of the underlying transferred asset over the transaction's term. This new guidance is effective in the first interim reporting period beginning after December 15, 2014. However, for repurchase and securities lending transactions reported as secured borrowing, the new standard's enhanced disclosures are effective for annual periods beginning after December 15, 2014 and interim period beginning after March 15, 2015. We adopted the new guidance, as required, in the first quarter of 2015 and will adopt the

disclosure requirements in the second quarter of 2015, as required. The adoption in the first quarter of 2015 did not have a material impact on our financial statements, as we did not have repo-to-maturity transactions outstanding. In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers." The objective of the guidance is to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and IFRS. The Amendment supersedes most current revenue recognition guidance, including industry-specific guidance. The Amendment also enhances disclosure requirements

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

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

around revenue recognition and the related cash flows. The guidance is to be applied retrospectively to all prior periods presented or through a cumulative adjustment in the year of adoption, for interim and annual periods beginning after December 15, 2016. Early adoption is not permitted. We are currently evaluating the impact of adopting this new standard.

In January 2014, the FASB issued ASU 2014-04, "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure." This update to the receivable guidance clarifies when a creditor is considered to have received physical possession of residential real estate resulting from an in substance repossession or foreclosure. In addition, the amendments require disclosure of both: (i) the amount of foreclosed residential real estate property held by the creditor; and (ii) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The update requires the guidance to be applied using either a modified retrospective transition method or a prospective transition method for interim and annual periods beginning after December 15, 2014, with early adoption permitted. We adopted this standard in the first quarter of 2015, as required, and it did not have a material impact on our 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, 2015 and December 31, 2014.

Offsetting of Financial Assets, Liabilities, and Collateral

	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
March 31, 2015 (In Thousands)						
Assets ⁽²⁾						
Interest rate agreements	\$17,554	\$—	\$17,554	\$(2,719)	\$(10,830)	\$4,005
TBA's	4,721	—	4,721	(4,667)	(54)	—
Total Assets	\$22,275	\$—	\$22,275	\$(7,386)	\$(10,884)	\$4,005
Liabilities ⁽²⁾						
Interest rate agreements	\$(57,581)	\$—	\$(57,581)	\$2,719	\$54,862	\$—
TBA's	(8,842)	—	(8,842)	4,666	3,201	(975)
Futures	(332)	—	(332)	—	332	—
Loan warehouse debt	(895,895)	—	(895,895)	895,895	—	—
Security repurchase agreements	(606,269)	—	(606,269)	606,269	—	—
Total Liabilities	\$(1,568,919)	\$—	\$(1,568,919)	\$1,509,549	\$58,395	\$(975)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

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

December 31, 2014 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet ⁽¹⁾			Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged		
Assets ⁽²⁾							
Interest rate agreements	\$7,006	\$—	\$7,006	\$(1,160)	) \$(4,360	)	\$1,486
Credit default index swaps	1,598	—	1,598	—	(375	)	1,223
TBAs	6,653	—	6,653	(5,815	) —		838
Total Assets	\$15,257	\$—	\$15,257	\$(6,975)	) \$(4,735	)	\$3,547
Liabilities ⁽²⁾							
Interest rate agreements	\$(48,173)	) \$—	\$(48,173)	) \$1,160	47,013		\$—
TBAs	(9,506)	) —	(9,506)	) 5,815	2,715	(976)
Futures	(372)	) —	(372)	) —	372		—
Loan warehouse debt	(1,185,316)	) —	(1,185,316)	) 1,185,316	—		—
Security repurchase agreements	(608,509)	) —	(608,509)	) 608,509	—		—
Total Liabilities	\$(1,851,876)	\$—	\$(1,851,876)	\$1,800,800	\$50,100	\$(976)

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) balance sheets. Loan warehouse debt, which is secured by residential and commercial mortgage loans, and security repurchase agreements are components of short-term debt on our consolidated balance sheets.

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

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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 4. Principles of Consolidation - (continued)

Analysis of Consolidated VIEs

As of March 31, 2015, the VIEs we are required to consolidate include certain Sequoia securitization entities, the Residential Resecuritization entity, and the Commercial Securitization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities 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.

Assets and Liabilities of Consolidated VIEs

March 31, 2015 (Dollars in Thousands)	Sequoia Entities	Residential Resecuritization	Commercial Securitization	Total
Residential loans, held-for-investment	\$1,304,426	\$—	\$—	\$1,304,426
Commercial loans, held-for-investment	—	—	191,575	191,575
Real estate securities	—	211,316	—	211,316
Restricted cash	147	—	135	282
Accrued interest receivable	1,720	449	1,491	3,660
Other assets	5,304	—	—	5,304
Total Assets	\$1,311,597	\$211,765	\$193,201	\$1,716,563
Accrued interest payable	\$893	\$10	\$374	\$1,277
Asset-backed securities issued	1,239,065	34,280	79,676	1,353,021
Total Liabilities	\$1,239,958	\$34,290	\$80,050	\$1,354,298
Number of VIEs	24	1	1	26

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 23 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, 2015 and 2014.

Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended March 31,	
	2015	2014
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	—

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 4. Principles of Consolidation - (continued)

The following table summarizes the cash flows during the three months ended March 31, 2015 and 2014 between us and the unconsolidated VIEs sponsored by us.

Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Proceeds from new transfers	\$341,716	\$—
MSR fees received	3,770	3,423
Funding of compensating interest	(90)	(33)
Cash flows received on retained securities	12,645	12,303

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

Assumptions Related to Assets Retained from Unconsolidated VIEs Sponsored by Redwood

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

The following table presents additional information at March 31, 2015 and December 31, 2014, related to unconsolidated securitizations accounted for as sales since 2012.

Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	March 31, 2015	December 31, 2014
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	\$69,258	\$93,802
Senior and subordinate securities, classified as AFS	391,296	460,990
Maximum loss exposure ⁽¹⁾	460,554	554,792
Assets transferred:		
Principal balance of loans outstanding	7,287,906	7,276,825
Principal balance of delinquent loans 30+ days delinquent	20,952	17,022

Maximum loss exposure from our involvement with unconsolidated VIEs pertains to the carrying value of our securities retained from these VIEs and represents estimated losses that would be incurred under severe,

(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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 4. Principles of Consolidation - (continued)

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at March 31, 2015 and December 31, 2014.

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

March 31, 2015 (Dollars in Thousands)	MSRs	Senior Securities	Subordinate Securities		
Fair value at March 31, 2015	\$50,156	\$65,809	\$394,745		
Expected life (in years) ⁽¹⁾	6	6	11		
Prepayment speed assumption (annual CPR) ⁽¹⁾	17	% 11	% 10		%
Decrease in fair value from:					
10% adverse change	\$2,329	\$3,697	\$905		
25% adverse change	5,530	7,035	2,356		
Discount rate assumption ⁽¹⁾	11	% 10	% 5		%
Decrease in fair value from:					
100 basis point increase	\$1,645	\$2,540	\$30,841		
200 basis point increase	3,216	4,899	57,886		
Credit loss assumption ⁽¹⁾	N/A	0.25	% 0.25		%
Decrease in fair value from:					
10% higher losses	N/A	\$345	\$2,397		
25% higher losses	N/A	456	5,704		
December 31, 2014 (Dollars in Thousands)	MSRs	Senior Securities	Subordinate Securities		
Fair value at December 31, 2014	\$56,801	\$93,802	\$460,990		
Expected life (in years) ⁽¹⁾	7	6	10		
Prepayment speed assumption (annual CPR) ⁽¹⁾	14	% 9	% 10		%
Decrease in fair value from:					
10% adverse change	\$2,419	\$3,999	\$684		
25% adverse change	5,639	9,475	2,355		
Discount rate assumption ⁽¹⁾	11	% 8	% 5		%
Decrease in fair value from:					
100 basis point increase	\$2,104	\$4,214	\$34,149		
200 basis point increase	4,102	8,091	64,474		
Credit loss assumption ⁽¹⁾	N/A	0.25	% 0.25		%
Decrease in fair value from:					
10% higher losses	N/A	\$126	\$3,169		
25% higher losses	N/A	299	7,841		

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 4. Principles of Consolidation - (continued)

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at March 31, 2015, grouped by security type.

Third-Party Sponsored VIE Summary

(Dollars in Thousands)

March 31, 2015

Residential Mortgage Backed Securities

Senior

\$480,200

Re-REMIC

169,240

Subordinate

175,250

Total Investments in Third-Party Sponsored VIEs

\$824,690

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.

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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(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, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015		December 31, 2014	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	\$1,093,413	\$1,093,413	\$1,341,032	\$1,341,032
At lower of cost or fair value	1,472	1,663	1,488	1,669
Residential loans, held-for-investment ⁽¹⁾				
At fair value	2,304,870	2,304,870	581,668	581,668
At amortized cost	—	—	1,474,386	1,381,918
Commercial loans, held-for-sale	54,407	54,407	166,234	166,234
Commercial loans, held-for-investment				
At fair value	72,619	72,619	71,262	71,262
At amortized cost	333,316	338,932	329,431	334,876
Trading securities	106,837	106,837	111,606	111,606
Available-for-sale securities	1,178,406	1,178,406	1,267,624	1,267,624
MSRs	120,324	120,324	139,293	139,293
Cash and cash equivalents	303,820	303,820	269,730	269,730
Restricted cash	725	725	628	628
Accrued interest receivable	17,970	17,970	18,222	18,222
Derivative assets	30,546	30,546	16,417	16,417
REO ⁽²⁾	5,305	5,446	4,391	4,703
Margin receivable ⁽²⁾	79,760	79,760	65,374	65,374
FHLBC stock ⁽²⁾	28,434	28,434	10,688	10,688
Guarantee asset ⁽²⁾	6,118	6,118	7,201	7,201
Pledged collateral ⁽²⁾	10,265	10,265	9,927	9,927
Liabilities				
Short-term debt	\$1,502,164	\$1,502,164	\$1,793,825	\$1,793,825
Accrued interest payable	14,319	14,319	8,502	8,502
Guarantee obligation	6,917	6,917	7,201	7,201
Derivative liabilities	68,064	68,064	58,331	58,331
ABS issued ⁽¹⁾				
Fair value	1,239,065	1,239,065	—	—
Amortized cost	113,956	114,613	1,545,119	1,446,605
FHLBC borrowings	850,792	850,792	495,860	495,860
Commercial secured borrowings	68,077	68,077	66,707	66,707
Convertible notes	492,500	488,243	492,500	492,188
Other long-term debt	139,500	97,650	139,500	101,835
(1)				

Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment and ABS issued by consolidated Sequoia entities began to be recorded at fair value. See Note 3 for further discussion.
(2) These assets are included in Other Assets on our consolidated balance sheets.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

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

During the three months ended March 31, 2015, we elected the fair value option for \$23 million of residential subordinate securities, \$2.40 billion of residential loans (principal balance), \$93 million of commercial loans (principal balance), and \$19 million of MSRs, respectively. We anticipate electing the fair value option for all future purchases of residential loans and commercial senior loans that we intend to sell to third parties or transfer to securitizations 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, 2015, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis at March 31, 2015

March 31, 2015 (In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Assets				
Residential loans	\$3,398,283	\$—	\$200,869	\$3,197,414
Commercial loans	127,026	—	—	127,026
Trading securities	106,837	—	—	106,837
Available-for-sale securities	1,178,406	—	—	1,178,406
Derivative assets	30,546	4,721	17,554	8,271
MSRs	120,324	—	—	120,324
Pledged collateral	10,265	10,265	—	—
FHLBC stock	28,434	28,434	—	—
Guarantee asset	6,118	—	—	6,118
Liabilities				
Derivative liabilities	68,064	9,173	58,045	846
Commercial secured borrowings	68,077	—	—	68,077
ABS issued	1,239,065	—	—	1,239,065

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(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, 2015.

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

	Assets					Liabilities				
(In Thousands)	Residential Loans	Commercial Loans	Trading Securities	AFS Securities	MSRs	Guarantee Asset	Derivative	Commercial Secured Borrowings	ABS Issued	
Beginning balance - December 31, 2014	\$1,677,984	\$237,496	\$111,606	\$1,267,624	\$139,293	\$7,201	\$1,119	\$66,707	\$—	
Transfer to FVO ⁽²⁾	1,370,699	—	—	—	—	—	—	—	1,302,216	
Principal paydowns	(111,716)	(240)	(203)	(26,110)	—	—	—	(152)	(66,517)	
Amortization income	—	—	—	9,838	—	—	—	—	—	
Gains (losses) in net income, net	7,570	7,366	(14,114)	4,306	(19,517)	(1,083)	20,087	1,509	2,946	
Unrealized gains in OCI, net	—	—	—	3,795	—	—	—	—	—	
Acquisitions	1,112,042	92,713	23,084	9,831	18,754	—	—	—	—	
Sales	(857,249)	(210,309)	(13,536)	(90,878)	(18,206)	—	—	—	—	
Other settlements, net	(1,916)	—	—	—	—	—	(13,781)	13	421	
Ending balance - March 31, 2015	\$3,197,414	\$127,026	\$106,837	\$1,178,406	\$120,324	\$6,118	\$7,425	\$68,077	\$1,239,066	

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

(2) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment in, and ABS issued by, consolidated financial entities are now recorded at fair value. See Note 3 for further discussion.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(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, 2015 and 2014. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three months ended March 31, 2015 and 2014 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at March 31, 2015 and 2014 Included in Net Income

(In Thousands)	Included in Net Income	
	Three Months Ended March 31, 2015	2014
Assets		
Residential loans at Redwood	\$5,464	\$3,483
Residential loans at consolidated Sequoia entities	1,179	—
Commercial loans	2,959	2,530
Trading securities	(13,790)	(4,431)
Available-for-sale securities	—	(113)
MSRs	(11,769)	(2,291)
Loan purchase commitments	7,422	—
Other assets - Guarantee asset	(1,083)	—
Liabilities		
Loan purchase commitments	—	(235)
Commercial secured borrowing	(1,509)	—
ABS issued	(2,946)	—

The following table presents information on assets recorded at fair value on a non-recurring basis at March 31, 2015. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at March 31, 2015.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at March 31, 2015

March 31, 2015 (In Thousands)	Carrying Value	Fair Value Measurements Using			Gain (Loss) for Three Months Ended March 31, 2015
		Level 1	Level 2	Level 3	
Assets					
Residential loans, at lower of cost or fair value	\$1,103	\$—	\$—	\$1,103	\$—
REO	3,410	—	—	3,410	(74)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

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

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the three months ended March 31, 2015 and 2014.

Market Valuation Adjustments, Net

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Mortgage banking activities		
Residential loans, at fair value	\$2,056	\$7,128
Commercial loans, at fair value	5,857	3,626
Sequoia IO securities	(14,359)	) (4,277)
Risk management derivatives, net	(10,583)	) (7,082)
Loan purchase and forward sale commitments	18,256	8
Total mortgage banking activities ⁽¹⁾	1,227	(597)
MSRs	(19,517)	) (2,711)
Other		
Residential loans, at lower of cost or fair value	\$2	\$ (2)
Consolidated Sequoia entities ⁽²⁾	(1,093)) —
Residential loans held-for-investment, at Redwood	1,978	—
Trading securities	270	(154)
Impairments on AFS securities	—	(113)
Other risk management derivative instruments, net	(1,374)	) (5,727)
Guarantee asset	(1,083)) —
Other	155	(142)
Total other	(1,145)	) (6,138)
Total Market Valuation Adjustments, Net	\$(19,435)	) \$(9,446)

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

On January 1, 2015, we adopted ASU 2014-13 and began to record the assets and liabilities of consolidated Sequoia entities at fair value. This amount represents the net change in fair value of the consolidated assets and (2) liabilities of these entities, which include residential loans held-for-investment, REO, and ABS issued. This amount also represents the estimated change in value of our retained interests in these entities. See Note 3 for further discussion.

At March 31, 2015, our valuation policy and process had not changed from those described in our Annual Report on Form 10-K. 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.

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MSRs	120,324	Discount rate	9 - 11	%	10	%
		Prepayment rate (Annual CPR)	4 - 60	%	14	%
		Per loan annual cost to service	\$ 72 - 82		\$77	
Guarantee asset	6,118	Discount rate	11 - 11	%	11	%
		Prepayment rate (Annual CPR)	5 - 27	%	12	%
REO	3,410	Loss severity	31 - 66	%	46	%
Loan purchase commitments, net ⁽²⁾	7,425	MSR Multiple	0.0 - 5.7	x	3.5	x
		Fallout rate	2 - 98	%	33	%
Liabilities						
ABS issued by consolidated Sequoia entities ⁽¹⁾	1,239,065	Discount rate	4 - 8	%	5	%
		Prepayment rate (Annual CPR)	0 - 31	%	13	%
		Default rate	0 - 12	%	6	%
		Loss severity	20 - 32	%	26	%
		Credit support	0 - 65	%	11	%
Commercial secured financing	68,077	Spread to swap rate	156 - 156	bps	156	bps
		Credit support	23 - 23	%	23	%

(1) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment in, and ABS issued by, consolidated Sequoia entities began to be recorded at fair value. In accordance with this new guidance, the fair value of the loans in these entities were based on the fair value of the liabilities issued by these entities, which we determined were more readily observable. See Note 3 for further discussion.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(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 based on either an exit price to securitization or the whole loan market. For loans valued based on an exit to securitization, significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the limited availability of market quotes on newly issued RMBS and related inputs. Relevant market indicators that are factored into the analyses include third-party RMBS sales and pricing points for secondary sales of RMBS we have issued in past periods (which both provide indicative spreads to indexed TBA prices for senior securities and indexed swap rates for subordinate securities), as well as Agency RMBS, indexed swap yields, credit rating agency guidance on expected credit support levels for newly issued RMBS transactions, interest rates, and prepayment rates (Level 3). These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed or credit support assumptions.

For loans valued based on an exit to the whole loan market, significant inputs in the valuation analysis are predominantly Level 3 in nature. Relevant market indicators that are factored into the analyses include prices on recent sales of our own whole loans and third-party whole loan sales (which provide indicative spreads to indexed swap rates), indexed swap yields, interest rates, and prepayment rates (Level 3). These assets would generally decrease in value based upon an increase in the credit spread assumption.

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 securities 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 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 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 serious delinquencies or loss severities, or a decrease in prepayment rates or credit support.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(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, 2015, we received dealer price indications on 81% of our securities, representing 93% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were 2% lower than 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, LPCs, and FSCs. Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets. TBA and financial futures fair values are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2). LPC fair values are estimated based on quoted Agency MBS prices, estimates of the fair value of the MSRs we expect to retain in the sale of the loans, and the probability that the mortgage loan will be purchased (Level 3). FSC fair values are obtained using quoted Agency prices. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2).

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

MSRs

MSRs 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, which is what we believe market participants would use to estimate fair value (Level 3). These discounted cash flow models utilize certain significant unobservable inputs including prepayment rate and discount rate assumptions. An increase in these unobservable inputs will reduce the estimated fair value of the MSRs.

As part of our MSR valuation process, we received a valuation estimate from a third-party valuations firm. In the aggregate, our internal valuation of the MSRs was less than 2% lower than 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 FHLBC 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 1).

Guarantee Asset

The guarantee asset represents the estimated fair value of cash flows we are contractually entitled to receive related to our risk sharing arrangement with Fannie Mae. Significant inputs in the valuation analysis are Level 3, due to the nature of this instrument 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 will reduce the estimated fair value of the guarantee asset.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(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 process 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 1).

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 1).

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. For ABS issued, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Relevant market indicators factored into the analyses include bid/ask spreads, 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.

As part of our ABS issued valuation process, we also request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at March 31, 2015, we received dealer price indications on 36% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were 1% higher than the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis.

FHLBC Borrowings

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

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

FHLBC borrowings include amounts borrowed from the FHLBC that are secured 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 1).

Commercial secured borrowings

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

Convertible notes

Convertible notes include unsecured convertible 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, 2015 and December 31, 2014.

March 31, 2015

(In Thousands)	Redwood	Sequoia ⁽¹⁾	Total
Held-for-sale			
Fair value - conforming	\$200,869	\$—	\$200,869
Fair value - jumbo	892,544	—	892,544
Lower of cost or fair value	1,472	—	1,472
Held-for-investment			
Fair value - Jumbo	1,000,444	1,304,426	2,304,870
Total Residential Loans	\$2,095,329	\$1,304,426	\$3,399,755

December 31, 2014

(In Thousands)	Redwood	Sequoia ⁽¹⁾	Total
Held-for-sale			
Fair value - conforming	\$244,714	\$—	\$244,714
Fair value - jumbo	1,096,317	—	1,096,317
Lower of cost or fair value	1,488	—	1,488
Held-for-investment			
Fair value - jumbo	581,668	—	581,668
At amortized cost	—	1,474,386	1,474,386
Total Residential Loans	\$1,924,187	\$1,474,386	\$3,398,573

(1) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment at consolidated Sequoia entities began to be recorded at fair value. See Note 3 for further discussion.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 6. Residential Loans - (continued)

At March 31, 2015, we owned mortgage servicing rights associated with \$1.91 billion of consolidated residential loans purchased from third-party originators. The value of these MSRs is included in the carrying value of the associated loans on our balance sheet. We contract with a licensed sub-servicer that performs servicing functions for these loans.

Residential Loans Held-for-Sale

Residential Loans at Fair Value

At March 31, 2015, we owned 1,903 held-for-sale loans with an unpaid principal balance of \$1.07 billion, compared to 2,273 loans with an unpaid principal balance of \$1.30 billion at December 31, 2014. At March 31, 2015 and December 31, 2014, none of these loans were greater than 90 days delinquent and none of the loans were in foreclosure.

During the three months ended March 31, 2015 and 2014, we purchased \$2.40 billion and 1.07 billion (principal balance) of loans, respectively, for which we elected the fair value option and recorded \$2 million and \$7 million of positive valuation adjustments, respectively, on residential loans held-for-sale at fair value through mortgage banking activities, a component of our consolidated income statement. During the three months ended March 31, 2015 and 2014, we sold \$2.20 billion and \$707 million (principal balance) of loans held-for-sale, respectively.

Residential Loans at Lower of Cost or Fair Value

At March 31, 2015 and December 31, 2014, 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.

Residential Loans Held-for-Investment at Fair Value

Residential Loans at Redwood

During the three months ended March 31, 2015, we transferred loans with a principal balance of \$436 million and a fair value of \$448 million from held-for-sale to held-for-investment bringing the total amount of loans held-for-investment at fair value to \$1.00 billion at March 31, 2015. At March 31, 2015, \$994 million of these loans were pledged as collateral under a borrowing agreement with the FHLBC.

At March 31, 2015, we owned 1,314 held-for-investment loans at Redwood with an unpaid principal balance of \$972 million, compared to 803 loans with an unpaid principal balance of \$566 million at December 31, 2014. At March 31, 2015 and December 31, 2014, none of these loans were greater than 90 days delinquent and none of the loans were in foreclosure.

The outstanding loans held-for-investment at Redwood at March 31, 2015 were originated in 2014 and 2015 and the weighted average FICO score of borrowers backing these loans was 773 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 68% (at origination). At March 31, 2015, these loans were comprised of fixed-rate loans with a weighted average coupon of 3.92%, and hybrid loans with a weighted average coupon of 3.06%.

Residential Loans at Consolidated Sequoia Entities

On January 1, 2015, we eliminated \$13 million of unamortized premium, net and \$21 million of allowance for loan losses, related to loans at our consolidated Sequoia entities as part of our initial adoption of ASU 2014-13 and recorded a valuation adjustment on these loans to reduce the loan carrying values to their estimated fair values. See Note 3 for further discussion.

The following table details the carrying value for residential loans held-for-investment at consolidated Sequoia entities at March 31, 2015 and December 31, 2014.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 6. Residential Loans - (continued)

(In Thousands)	March 31, 2015	December 31, 2014
Principal balance	\$ 1,415,017	\$ 1,483,213
Unamortized premium, net	—	12,511
Allowance for loan losses	—	(21,338)
Valuation adjustment	(110,591)	—
Carrying value	\$ 1,304,426	\$ 1,474,386

At March 31, 2015, we owned 5,177 held-for-investment loans at consolidated Sequoia entities, as compared to 5,315 loans at December 31, 2014. The weighted average FICO score of borrowers backing these loans was 733 (at origination) and the weighted average LTV ratio of these loans was 66% (at origination). At March 31, 2015 and December 31, 2014, the unpaid principal balance of loans at consolidated Sequoia entities delinquent greater than 90 days was \$68 million and \$73 million, respectively, and the unpaid principal balance of loans in foreclosure was \$34 million and \$39 million, respectively. During the three months ended March 31, 2015, we recorded positive \$3 million of valuation adjustments on these loans through other market valuation adjustments on our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 7. Commercial Loans

We invest in commercial loans that we originate as well as loans that we acquire from third-party originators. The following table summarizes the classifications and carrying value of commercial loans at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015	December 31, 2014
Held-for-sale, at fair value	\$54,407	\$166,234
Held-for-investment		
At fair value	72,619	71,262
At amortized cost	333,316	329,431
Total Commercial Loans	\$460,342	\$566,927

Of the held-for-investment commercial loans at amortized cost shown above at March 31, 2015 and December 31, 2014, \$192 million and \$195 million, respectively, were financed through the Commercial Securitization entity.

Commercial Loans Held-for-Sale

Commercial loans held-for-sale include loans we originate and intend to sell to third parties. At March 31, 2015, we held five senior commercial mortgage loans at fair value, with an aggregate outstanding principal balance of \$53 million and an aggregate fair value of \$54 million. As of December 31, 2014, there were 13 senior commercial mortgage loans at fair value, with an aggregate outstanding principal balance of \$163 million and an aggregate fair value of \$166 million. During the three months ended March 31, 2015, we acquired \$93 million (principal balance) of senior commercial loans for which we elected the fair value option and sold \$203 million (principal balance) of loans to third parties. During the three months ended March 31, 2015 and 2014, we recorded positive \$6 million and positive \$2 million, respectively, of valuation adjustments on senior commercial mortgage loans for which we elected the fair value option through mortgage banking activities on our consolidated statements of income.

Commercial Loans Held-for-Investment

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, 2015, we held three of these A/B notes with an aggregate outstanding principal balance of \$67 million and an aggregate fair value of \$73 million. At December 31, 2014, we held three A/B notes, with an aggregate outstanding principal balance of \$68 million and an aggregate fair value of \$71 million. During the three months ended March 31, 2015 and 2014, we recorded positive \$2 million and positive \$1 million, respectively, of valuation adjustments on commercial loans held-for-investment at fair value through mortgage banking activities, a component of our consolidated income statement.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 7. Commercial Loans - (continued)

Commercial Loans Held-for-Investment, at Amortized Cost

Commercial loans held-for-investment at amortized cost include loans we originate and preferred equity investments we make or, in either case, acquire from third parties. As of March 31, 2015, these loans primarily include mezzanine loans that are secured by a borrower's ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. The preferred equity investments are typically preferred equity interests in a single purpose entity that owns commercial property and are included within, and referred to herein, as commercial loans held-for-investment due to the fact that their risks and payment characteristics are nearly equivalent to commercial mezzanine loans.

The following table provides additional information for our commercial loans held-for-investment at amortized cost at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015	December 31, 2014
Principal balance	\$345,646	\$341,750
Unamortized discount, net	(4,668)	(4,862)
Recorded investment	340,978	336,888
Allowance for loan losses	(7,662)	(7,457)
Carrying Value	\$333,316	\$329,431

At March 31, 2015 and December 31, 2014, we held 62 and 60 commercial loans held-for-investment at amortized cost, respectively. During the three months ended March 31, 2015, we originated or acquired \$8 million of commercial loans held-for-investment at amortized cost. Of the \$341 million of recorded investment in commercial loans held-for-investment at March 31, 2015, 2% was originated in 2015, 17% was originated in 2014, 17% was originated in 2013, 36% was originated in 2012, 24% 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.

(In Thousands)	March 31, 2015	December 31, 2014
Pass	\$320,075	\$316,122
Watch list	25,571	25,628
Total Commercial Loans Held-for-Investment	\$345,646	\$341,750

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 7. Commercial Loans - (continued)

Activity in the Allowance for Loan Losses on Commercial Loans

The following table summarizes the activity in the allowance for commercial loan losses for the three months ended March 31, 2015 and 2014.

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Balance at beginning of period	\$7,456	\$7,373
Charge-offs, net	—	—
Provision for loan losses	206	655
Balance at End of Period	\$7,662	\$8,028

Commercial Loans Collectively Evaluated for Impairment

At March 31, 2015 and December 31, 2014, all of our commercial loans collectively evaluated for impairment were current. The following table summarizes the balances for loans collectively evaluated for impairment at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015	December 31, 2014
Principal balance	\$345,646	\$341,750
Recorded investment	340,978	336,888
Related allowance	7,662	7,457

Commercial Loans Individually Evaluated for Impairment

We did not have any commercial loans individually evaluated for impairment at either March 31, 2015 or December 31, 2014.

Note 8. Real Estate Securities

We invest in residential mortgage-backed securities. The following table presents the fair values of our real estate securities by type at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015	December 31, 2014
Trading	\$106,837	\$111,606
Available-for-sale	1,178,406	1,267,624
Total Real Estate Securities	\$1,285,243	\$1,379,230

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

Trading Securities

We elected the fair value option for certain securities and classify them as trading securities. At March 31, 2015, our trading securities included \$70 million of interest-only securities, for which there is no principal balance, \$4 million of senior securities and \$33 million of subordinate securities. The unpaid principal balance of senior and subordinate securities classified as trading securities was \$4 million and \$45 million, respectively, at March 31, 2015. During the three months ended March 31, 2015, we acquired \$23 million (principal balance) of senior and subordinate securities for which we elected the fair value option and classified as trading, and sold \$3 million of securities. During the three months ended March 31, 2015 and 2014, we recorded negative \$14 million and negative \$4 million,

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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March 31, 2015

(Unaudited)

Note 8. Real Estate Securities - (continued)

respectively, of valuation adjustments on trading securities, with portions of these adjustments included in mortgage banking activities and other market valuation adjustments on our consolidated income statements.

The following table presents trading securities by collateral type at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015	December 31, 2014
Senior Securities		
Prime	\$65,809	\$93,802
Non-prime	7,454	7,951
Total Senior Securities	73,263	101,753
Prime Subordinate Securities	33,574	9,853
Total Trading Securities	\$106,837	\$111,606

AFS Securities

The following table presents the fair value of our available-for-sale securities held at Redwood by collateral type at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015	December 31, 2014
Senior Securities		
Prime	\$297,872	\$307,813
Non-prime	174,874	179,744
Total Senior Securities	472,746	487,557
Re-REMIC Securities	169,239	168,347
Subordinate Securities		
Prime Mezzanine ⁽¹⁾	370,391	448,838
Subordinate ⁽²⁾	166,030	162,882
Total Subordinate Securities	536,421	611,720
Total AFS Securities	\$1,178,406	\$1,267,624

(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, 2015, and December 31, 2014.

The senior securities shown above at March 31, 2015 and December 31, 2014, included \$98 million and \$105 million, respectively, of prime securities, and \$113 million and \$117 million, respectively, of non-prime securities that were financed through the Residential Resecuritization entity, as discussed in Note 4.

During the three months ended March 31, 2015, we purchased \$10 million of AFS securities and sold \$91 million of AFS securities, which resulted in realized gains of \$4 million. During the three months ended March 31, 2014, we purchased \$74 million of AFS securities and sold none.

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, 2015, there were \$7 million of AFS securities with contractual maturities less than five years, \$2 million of AFS securities 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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(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, 2015 and December 31, 2014.

Carrying Value of AFS Securities

March 31, 2015	Senior				
(In Thousands)	Prime	Non-prime	Re-REMIC	Subordinate	Total
Principal balance	\$302,046	\$190,790	\$194,296	\$648,490	\$1,335,622
Credit reserve	(2,830)	(9,027)	(12,667)	(39,060)	(63,584)
Unamortized discount, net	(32,645)	(29,791)	(79,401)	(144,545)	(286,382)
Amortized cost	266,571	151,972	102,228	464,885	985,656
Gross unrealized gains	33,313	22,984	67,011	72,328	195,636
Gross unrealized losses	(2,012)	(82)	—	(792)	(2,886)
Carrying Value	\$297,872	\$174,874	\$169,239	\$536,421	\$1,178,406
December 31, 2014	Senior				
(In Thousands)	Prime	Non-prime	Re-REMIC	Subordinate	Total
Principal balance	\$311,573	\$196,258	\$195,098	\$742,150	\$1,445,079
Credit reserve	(3,660)	(9,644)	(15,202)	(41,561)	(70,067)
Unamortized discount, net	(34,782)	(31,491)	(79,611)	(150,458)	(296,342)
Amortized cost	273,131	155,123	100,285	550,131	1,078,670
Gross unrealized gains	35,980	24,682	68,062	63,026	191,750
Gross unrealized losses	(1,298)	(61)	—	(1,437)	(2,796)
Carrying Value	\$307,813	\$179,744	\$168,347	\$611,720	\$1,267,624

The following table presents the changes for the three ended March 31, 2015, in unamortized discount and designated credit reserves on residential AFS securities.

Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

(In Thousands)	Three Months Ended March 31, 2015	
	Credit Reserve	Unamortized Discount, Net
Beginning balance	\$70,067	\$296,342
Amortization of net discount	—	(9,838)
Realized credit losses	(2,945)	—
Acquisitions	—	2,672
Sales, calls, other	—	(6,332)
Impairments	—	—
Transfers to (release of) credit reserves, net	(3,538)	3,538
Ending Balance	\$63,584	\$286,382

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Note 8. Real Estate Securities - (continued)

AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at March 31, 2015 and December 31, 2014.

(In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
March 31, 2015	\$143,665	\$(1,798)	\$141,867	\$36,468	\$(1,088)	\$35,380
December 31, 2014	126,681	(1,374)	125,307	70,676	(1,422)	69,254

At March 31, 2015, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 274 AFS securities, of which 29 were in an unrealized loss position and eight were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2014, our consolidated balance sheet included 290 AFS securities, of which 31 were in an unrealized loss position and 10 were in a continuous unrealized loss position for 12 consecutive months or longer.

Evaluating AFS Securities for Other-than-Temporary Impairments

Gross unrealized losses on our AFS securities were \$3 million at March 31, 2015. We evaluate all securities in an unrealized loss position to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). At March 31, 2015, we did not intend to sell any of our AFS securities that were in an unrealized loss position, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity. We review our AFS securities that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent security performance and expected future performance of the underlying collateral.

During the three months ended March 31, 2015, we recognized no OTTI losses related to our AFS securities. AFS securities for which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. In determining our estimate of cash flows for AFS securities we may consider factors such as structural credit enhancement, past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, which are informed by prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, and geographic concentrations, as well as general market assessments. Changes in our evaluation of these factors impacted the cash flows expected to be collected at the OTTI assessment date and were used to determine if there were credit-related adverse cash flows and if so, the amount of credit related losses. Significant judgment is used in both our analysis of the expected cash flows for our AFS securities and any determination of the credit loss component of OTTI.

The table below summarizes the significant valuation assumptions we used for our AFS securities in unrealized loss positions at March 31, 2015.

Significant Valuation Assumptions

March 31, 2015	Range for Securities	
	Prime	Non-prime
Prepayment rates	8 - 16%	10 - 10%
Projected losses	1 - 18%	14 - 18%

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Note 8. Real Estate Securities - (continued)

The following table details the activity related to the credit loss component of OTTI (i.e., OTTI recognized through earnings) for AFS securities held at March 31, 2015 and 2014, for which a portion of an OTTI was recognized in other comprehensive income.

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

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Balance at beginning of period	\$33,849	\$37,149
Additions		
Initial credit impairments	—	71
Subsequent credit impairments	—	42
Reductions		
Securities sold, or expected to sell	(95) —
Securities with no outstanding principal at period end	(805	) (1,476
Balance at End of Period	\$32,949	\$35,786

Gross Realized Gains and Losses on AFS Securities

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains and losses on sales and calls of AFS securities for the three months ended March 31, 2015 and 2014.

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Gross realized gains - sales	\$4,306	\$—
Gross realized gains - calls	—	987
Gross realized losses - sales	—	—
Gross realized losses - calls	—	—
Total Realized Gains on Sales and Calls of AFS Securities, net	\$4,306	\$987

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Note 9. Mortgage Servicing Rights

We invest in mortgage servicing rights associated with residential mortgage loans and contract with a licensed sub-servicer to perform all servicing functions for these loans. The following table presents the fair value of MSR's and the aggregate principal amounts of associated loans as of March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015		December 31, 2014	
	MSR Fair Value	Associated Principal	MSR Fair Value	Associated Principal
Mortgage Servicing Rights				
Conforming Loans	\$69,203	\$6,800,645	\$81,301	\$7,705,146
Jumbo Loans	51,121	5,851,993	57,992	5,962,784
Total Mortgage Servicing Rights	\$120,324	\$12,652,638	\$139,293	\$13,667,930

The following table presents activity for MSR's for the three months ended March 31, 2015 and 2014.

MSR Activity

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Balance at beginning of period	\$139,293	\$64,824
Additions	18,754	2,858
Sales	(18,206)) —
Changes in fair value due to:		
Changes in assumptions ⁽¹⁾	(14,036	) (1,125)
Other changes ⁽²⁾	(5,481	) (1,586)
Balance at End of Period	\$120,324	\$64,971

(1) Primarily reflects changes in prepayment assumptions due to changes in market interest rates.

(2) Represents changes due to realization of expected cash flows.

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Note 9. Mortgage Servicing Rights - (continued)

We make investments in MSRs through the retention of servicing rights associated with the residential mortgage loans that we acquire and subsequently transfer to third parties or through the direct acquisition of MSRs sold by third parties. We hold our MSR investments at a taxable REIT subsidiary of ours. The following table details the retention and purchase of MSRs during the three months ended March 31, 2015.

MSR Additions

(In Thousands)	Three Months Ended March 31, 2015	
	MSR Fair Value	Associated Principal
Jumbo MSR additions:		
From securitization	\$1,872	\$227,852
From loan sales	92	10,145
Total jumbo MSR additions	1,964	237,997
Conforming MSR additions:		
From loan sales	\$13,711	\$1,352,658
From purchases	3,079	318,338
Total conforming MSR additions	16,790	1,670,996
Total MSR additions	\$18,754	\$1,908,993

MSR Income

The following table presents the components of our MSR income.

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Servicing income		
Income	\$9,716	\$3,633
Cost of sub-servicer	(1,229)	(316)
Net servicing income	8,487	3,317
Market valuation adjustments	(19,517)	(2,711)
MSR provision for repurchases	106	—
MSR income (loss)	\$(10,924)	\$606

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Note 10. Derivative Financial Instruments

The following table presents the fair value and notional amount of our derivative financial instruments at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015		December 31, 2014	
	Fair Value	Notional Amount	Fair Value	Notional Amount
Assets - Risk Management Derivatives				
Interest rate swaps	\$ 1,768	\$ 158,000	\$ —	\$ —
TBAs	4,721	691,000	6,654	1,074,000
Futures	—	—	—	—
Swaptions	15,786	825,000	7,006	575,000
Credit default index swaps	—	—	1,597	50,000
Assets - Other Derivatives				
Loan purchase commitments	8,271	1,405,347	1,160	288,467
Loan forward sale commitments	—	—	—	—
Total Assets	\$ 30,546	\$ 3,079,347	\$ 16,417	\$ 1,987,467
Liabilities - Cash Flow Hedges				
Interest rate swaps	\$(55,284)	) \$ 139,500	\$(46,845)	) \$ 139,500
Liabilities - Risk Management Derivatives				
Interest rate swaps	(2,297)	) 190,500	(1,328)	) 206,000
TBAs	(8,842)	) 1,230,000	(9,506)	) 1,110,000
Futures	(332)	) 72,000	(372)	) 90,000
Liabilities - Other Derivatives				
Loan purchase commitments	(846)	) 387,051	(41)	) 27,324
Loan forward sale commitments	(463)	) 99,475	(239)	) 102,793
Total Liabilities	\$(68,064)	) \$ 2,118,526	\$(58,331)	) \$ 1,675,617
Total Derivative Financial Instruments, Net	\$(37,518)	) \$ 5,197,873	\$(41,914)	) \$ 3,663,084
Risk Management Derivatives				

To manage, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheet, we may enter into derivative contracts. At March 31, 2015, we were party to swaps and swaptions with an aggregate notional amount of \$1.3 billion, TBA contracts sold with an aggregate notional amount of \$1.9 billion, and financial futures contracts with an aggregate notional amount of \$72 million. Net market valuation adjustments on risk management derivatives were negative \$12 million and negative \$13 million for the three months ended March 31, 2015 and 2014, respectively.

Loan Purchase and Forward Sale Commitments

LPCs and FSCs that qualify as derivatives are recorded at their estimated fair values. Net valuation adjustments on LPCs and FSCs were positive \$18 million, and less than negative \$1 million for the three months ended March 31, 2015 and 2014, and are reported through our consolidated statements of income in mortgage banking activities, net.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 10. Derivative Financial Instruments - (continued)

Derivatives Designated as Cash Flow Hedges

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

For the three months ended March 31, 2015 and 2014, changes in the values of designated cash flow hedges were negative \$8 million and negative \$9 million, respectively, and were recorded in accumulated other comprehensive income, a component of equity. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was \$54 million and \$46 million at March 31, 2015 and December 31, 2014, respectively. For both of the three months ended March 31, 2015 and 2014, we reclassified less than \$100 thousand of unrealized losses on derivatives to interest expense. Accumulated other comprehensive loss of less than \$1 million will be amortized into interest expense, a component of our consolidated income statements, over the remaining life of the hedge liabilities.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three months ended March 31, 2015 and 2014.

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

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Net interest expense on cash interest rate agreements	\$(1,484	) \$(1,488)
Realized expense due to ineffective portion of cash flow hedges	—	—
Realized net losses reclassified from other comprehensive income	(31	) (60)
Total Interest Expense	\$(1,515	) \$(1,548)

Derivative Counterparty Credit Risk

As discussed in our Annual report on Form 10-K, we consider counterparty risk as part of our fair value assessments of all derivative financial instruments. At March 31, 2015, we assessed this risk as remote and did not record a specific valuation adjustment.

At March 31, 2015, we had outstanding derivative agreements with six counterparties (other than clearinghouses) and were in compliance with ISDA agreements governing our open derivative positions.

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Note 11. Other Assets and Liabilities

Other Assets

Other assets at March 31, 2015 and December 31, 2014, are summarized in the following table.

(In Thousands)	March 31, 2015	December 31, 2014
Margin receivable	\$79,760	\$65,374
Investment receivable	31,578	1,103
FHLBC stock	28,434	10,688
Pledged collateral	10,265	9,927
Guarantee asset	6,118	7,201
Income tax receivables	5,786	175
REO	5,305	4,391
Deposits	5,000	5,000
Prepaid expenses	2,816	3,372
Fixed assets and leasehold improvements ⁽¹⁾	3,868	3,008
Other	4,062	3,657
Total Other Assets	\$182,992	\$113,896

(1) Fixed assets have a basis of \$6 million and accumulated depreciation of \$4 million at March 31, 2015.

Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities at March 31, 2015 and December 31, 2014 are summarized in the following table.

(In Thousands)	March 31, 2015	December 31, 2014
Margin payable	\$15,007	\$6,455
Unsettled trades	11,050	—
Accrued compensation	8,518	19,273
Guarantee obligation	6,917	7,201
Residential repurchase reserve	4,292	3,724
Accrued operating expenses	3,096	3,334
Legal reserve	2,000	2,000
Income tax payable	721	—
Other	8,534	10,257
Total Other Liabilities	\$60,135	\$52,244

Margin Receivable and Payable

Margin receivable and payable resulted from margin calls between us and our swap, master repurchase agreements, and warehouse facilities counterparties whereby we or the counterparty were required to post collateral.

Investment Receivable and Unsettled Trades

In accordance with our policy to record purchases and sales of securities on the trade date, if the trade and settlement of a purchase or sale crosses over a quarterly reporting period, we will record an investment receivable for sales and an unsettled trades liability for purchases. The amounts in the table above for each of these items were settled for cash subsequent to March 31, 2015.

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Note 11. Other Assets and Liabilities - (continued)

Guarantee Asset, Pledged Collateral, and Guarantee Obligation

The pledged collateral, guarantee asset, and guarantee obligation presented in the tables above are related to the risk sharing arrangement we entered into with Fannie Mae in the fourth quarter of 2014.

All of the loans in the reference pool subject to the guarantee were originated in 2014 and at March 31, 2015, the loans had an unpaid principal balance of \$957 million and an original weighted average FICO score of 762 and LTV of 75%. At March 31, 2015, 0.44% of the outstanding principal balance was 30 days or more delinquent and none of the loans were 90 days or more delinquent or in foreclosure. At March 31, 2015, the maximum potential amount of future payments we could be required to make under this obligation was \$10 million and this amount was fully collateralized by assets we have transferred to a custodian and are presented as pledged collateral in the table above. We have no recourse to any third parties that would allow us to recover any amounts related to this guarantee obligation. To date we have not incurred any losses under this agreement and as of March 31, 2015, we determined no allowance for contingent losses was required.

REO

The carrying value of REO at March 31, 2015, was \$5 million, which includes the net effect of \$3 million related to transfers into REO during three months ended March 31, 2015, offset by \$1 million of REO liquidations, and \$2 million of negative market valuation adjustments. At March 31, 2015 and December 31, 2014, there were 20 and 22 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Sequoia entities.

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

Note 12. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At March 31, 2015, we had outstanding agreements with several counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q and in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2014.

The table below summarizes the facilities that are available to us and the balances of short-term debt at March 31, 2015 and December 31, 2014 by the type of collateral securing the debt.

Short-Term Debt

(Dollars in Thousands)	March 31, 2015			
	Number of Facilities	Outstanding	Limit	Maturity
Collateral Type				
Residential loans	5	\$815,037	\$1,550,000	4/2015-2/2016
Commercial loans	3	80,858	400,000	4/2015-10/2016
Real estate securities	10	606,269	—	4/2015-6/2015
Total	18	\$1,502,164		

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Note 12. Short-Term Debt - (continued)

(Dollars in Thousands)	December 31, 2014			
	Number of Facilities	Outstanding	Limit	Maturity
Collateral Type				
Residential loans	5	\$1,076,188	\$1,550,000	2/2015-12/2015
Commercial loans	3	109,128	400,000	4/2015-10/2016
Real estate securities	9	608,509	—	1/2015-3/2015
Total	17	\$1,793,825		

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At March 31, 2015, all of these borrowings were under uncommitted facilities and were due within 364 days (or less) of the borrowing date.

The fair value of residential loans, commercial loans, and real estate securities pledged as collateral was \$915 million, \$125 million, and \$734 million, respectively, at March 31, 2015 and \$1.22 billion, \$161 million, and \$762 million, respectively, at December 31, 2014. For the three months ended March 31, 2015 and 2014, the average balance of short-term debt was \$1.59 billion and \$1.01 billion, respectively. At March 31, 2015 and December 31, 2014, accrued interest payable on short-term debt was \$2 million and \$2 million, respectively.

We also maintain a \$10 million committed line of credit with a financial institution that is secured by our pledge of certain mortgage-backed securities we own. At both March 31, 2015 and December 31, 2014, we had no outstanding borrowings on this facility.

Characteristics of Short-Term Debt

The table below summarizes short-term debt by weighted average interest rates and by collateral type at March 31, 2015 and December 31, 2014.

(Dollars in Thousands)	March 31, 2015			December 31, 2014		
	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
Collateral Type						
Residential loan collateral	\$815,037	1.74	% 191	\$1,076,188	1.74	% 156
Commercial loan collateral	80,858	4.40	% 288	109,128	3.66	% 185
Real estate securities collateral	606,269	1.38	% 26	608,509	1.38	% 20
Total Short-Term Debt	\$1,502,164	1.74	% 130	\$1,793,825	1.73	% 112

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of short-term debt at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015	December 31, 2014
Within 30 days	\$427,720	\$515,552
31 to 90 days	269,050	447,021
Over 90 days	805,394	831,252
Total Short-Term Debt	\$1,502,164	\$1,793,825

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Note 13. Asset-Backed Securities Issued

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

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

The carrying values of ABS issued by consolidated securitization entities we sponsored at March 31, 2015 and December 31, 2014, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

	March 31, 2015			
(Dollars in Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Certificates with principal balance	\$1,359,646	\$34,280	\$79,676	\$1,473,602
Interest-only certificates	5,622	—	—	5,622
Market valuation adjustments ⁽¹⁾	(126,203)	—	—	(126,203)
Total ABS Issued	\$1,239,065	\$34,280	\$79,676	\$1,353,021
Range of weighted average interest rates, by series	0.38% to 4.30%	2.17	% 5.62	%
Stated maturities	2017-2041	2046	2018	
Number of series	24	1	1	

(1) Upon adoption of ASU 2014-13 on January 1, 2015, we began to account for ABS issued by consolidated Sequoia entities at fair value. See Note 3 for further discussion.

	December 31, 2014			
(Dollars in Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Certificates with principal balance	\$1,427,056	\$45,044	\$83,313	\$1,555,413
Interest-only certificates	2,079	—	—	2,079
Unamortized discount	(12,373)	—	—	(12,373)
Total ABS Issued	\$1,416,762	\$45,044	\$83,313	\$1,545,119
Range of weighted average interest rates, by series	0.36% to 4.27%	2.16	% 5.62	%
Stated maturities	2014 - 2041	2046	2018	
Number of series	24	1	1	

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Note 13. Asset-Backed Securities Issued - (continued)

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its stated maturity. At March 31, 2015, \$1.35 billion of ABS issued (\$1.46 billion principal balance) had contractual maturities beyond five years and \$7 million of ABS issued (\$16 million principal balance) had contractual maturities of less than one year. Amortization of Commercial Securitization and Residential Resecuritization deferred ABS issuance costs was less than \$1 million for both the three months ended March 31, 2015 and 2014. The following table summarizes the accrued interest payable on ABS issued at March 31, 2015 and December 31, 2014. Interest due on consolidated ABS issued is payable monthly.

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	March 31, 2015	December 31, 2014
Sequoia	\$893	\$976
Residential Resecuritization	10	5
Commercial Securitization	374	390
Total Accrued Interest Payable on ABS Issued	\$1,277	\$1,371

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at March 31, 2015 and December 31, 2014.

Collateral for Asset-Backed Securities Issued

(In Thousands)	March 31, 2015			
	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Residential loans	\$1,304,426	\$—	\$—	\$1,304,426
Commercial loans	—	—	191,575	\$191,575
Real estate securities	—	211,316	—	\$211,316
Restricted cash	147	—	135	\$282
Accrued interest receivable	1,720	449	1,491	\$3,660
REO	5,304	—	—	\$5,304
Total Collateral for ABS Issued	\$1,311,597	\$211,765	\$193,201	\$1,716,563
(In Thousands)	December 31, 2014			
	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Residential loans	\$1,474,386	\$—	\$—	\$1,474,386
Commercial loans	—	—	194,991	\$194,991
Real estate securities	—	221,676	—	\$221,676
Restricted cash	147	43	137	\$327
Accrued interest receivable	2,359	477	1,511	\$4,347
REO	4,391	—	—	\$4,391
Total Collateral for ABS Issued	\$1,481,283	\$222,196	\$196,639	\$1,900,118

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Note 14. Long-Term Debt

FHLBC Borrowings

In July 2014, our FHLB member subsidiary entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. Under this agreement, our subsidiary may incur borrowings up to \$1 billion, also referred to as “advances,” from the FHLBC secured by eligible collateral, including, but not limited to residential mortgage loans and residential mortgage-backed securities. During the three months ended March 31, 2015, our FHLB-member subsidiary borrowed an additional \$355 million under this agreement. At March 31, 2015, \$851 million of advances were outstanding under this agreement with a weighted average interest rate of 0.27% and a weighted average maturity of 9.2 years. Advances under this agreement incur interest charges based on a specified margin over the FHLBC’s 13-week discount note rate, which resets every 13 weeks. These advances were secured by residential mortgage loans with a fair value of \$994 million at March 31, 2015. This agreement also requires our subsidiary to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of outstanding advances. At March 31, 2015, our subsidiary held \$28 million of FHLBC stock that is included in other assets in our consolidated balance sheets.

Commercial Secured Borrowing

At March 31, 2015, we had commercial secured borrowings of \$68 million resulting from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. We bifurcated certain of our senior commercial mortgage loans into a senior portion that was sold to a third party and a junior portion that we retained as an investment. Although GAAP requires us to record a secured borrowing liability when we receive cash from selling the senior portion of the loan, the liability has no economic substance to us in that it does not require periodic interest payments and has no maturity. For each commercial secured borrowing, at such time that the associated senior portion of the loan is repaid or we sell our retained junior portion, the secured borrowing liability and associated senior portion of the loan would be derecognized from our balance sheet.

Convertible Notes

In November 2014, RWT Holdings, Inc., a wholly-owned subsidiary of Redwood Trust, Inc., issued \$205 million principal amount of 5.625% exchangeable senior notes due 2019. These exchangeable notes require semi-annual interest payments at a fixed coupon rate of 5.625% until maturity or exchange, which will be no later than November 15, 2019. After deducting the underwriting discount and offering costs, we received \$198 million of net proceeds. Including amortization of deferred securities issuance costs, the interest expense yield on these exchangeable notes was 6.52% for the three months ended March 31, 2015. At March 31, 2015, the accrued interest payable balance on this debt was \$4 million and the unamortized deferred issuance costs were \$7 million. At March 31, 2015, these notes were exchangeable at the option of the holder at an exchange rate of 46.1798 common shares per \$1,000 principal amount of exchangeable senior notes (equivalent to an exchange price of \$21.65 per common share). Upon exchange of these notes by a holder, the holder will receive shares of our common stock. In March 2013, we issued \$288 million principal amount of 4.625% convertible senior notes due 2018. These convertible notes require semi-annual interest payments at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. After deducting the underwriting discount and offering costs, we received \$279 million of net proceeds. Including amortization of deferred securities issuance costs, the interest expense yield on these convertible notes was 5.36% for the three months ended March 31, 2015. At March 31, 2015, the accrued interest payable balance on this debt was \$7 million and the unamortized deferred issuance costs were \$5 million. At March 31, 2015, these notes were convertible at the option of the holder at a conversion rate of 41.1320 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of \$24.31 per

common share). Upon conversion of these notes by a holder, the holder will receive shares of our common stock.
Trust Preferred Securities and Subordinated Notes

At March 31, 2015, we had trust preferred securities and subordinated notes outstanding of \$100 million and \$40 million, respectively. The interest expense yield on both our trust preferred securities and subordinated notes was 2.52% and 2.42% for the three months ended March 31, 2015 and 2014, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on both our trust preferred securities and subordinated notes was 6.81% and 6.78% for the three months ended March 31, 2015 and 2014, respectively.

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(Unaudited)

Note 14. Long-Term Debt - (continued)

At both March 31, 2015 and December 31, 2014, the accrued interest payable balance on our trust preferred securities and subordinated notes was less than \$1 million. Under the terms of this debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is pari passu or subordinate to this debt.

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March 31, 2015

(Unaudited)

Note 15. Commitments and Contingencies

Lease Commitments

At March 31, 2015, we were obligated under nine non-cancelable operating leases with expiration dates through 2021 for \$12 million. Operating lease expense was less than \$1 million for both the three months ended March 31, 2015 and 2014.

The following table presents our future lease commitments at March 31, 2015.

Future Lease Commitments by Year

(In Thousands)	March 31, 2015
2015 (9 months)	\$2,123
2016	2,833
2017	2,879
2018	1,827
2019	1,189
2020 and thereafter	1,495
Total Lease Commitments	\$12,346

Loss Contingencies — Fannie Mae Risk Sharing

In the fourth quarter of 2014, we entered into a risk-sharing arrangement with Fannie Mae. Under this arrangement we committed to absorb the first one percent of losses realized on a reference pool of residential mortgage loans originated in 2014 that we acquired and then sold to Fannie Mae during the fourth quarter of 2014. During the 10 year term of the arrangement, we receive monthly cash payments from Fannie Mae based on the monthly outstanding unpaid principal balance of the reference pool of loans. Additionally, under this arrangement we are required to maintain collateral with a third party custodian sufficient to cover our maximum loss exposure throughout the term of the arrangement. To the extent approved losses are incurred, the custodian will transfer collateral to Fannie Mae. As a result of this transaction we recorded “pledged collateral” and a “guarantee asset” in the other assets line item, and a “guarantee obligation” in the other liabilities line item, on our consolidated balance sheets.

The guarantee obligation represents our commitment to absorb losses under the arrangement, which at inception was recorded at fair value based on the fair value of the guarantee asset. We are amortizing the guarantee obligation over the 10 year term of the arrangement based on changes in the outstanding unpaid principal balance of loans in the reference pool. In addition, each period we assess the need for a separate loss allowance related to this arrangement, based on our estimate of credit losses inherent in the reference pool of loans. To determine the loss allowance, we assess inherent losses in the reference pool of loans by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults). As of March 31, 2015, we determined a loss allowance was not required.

See Note 11 for further discussion of the risk share arrangement.

Loss Contingencies — Residential Repurchase Reserve

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

At both March 31, 2015 and December 31, 2014, our repurchase reserve associated with our residential loans and MSRs was \$4 million and was recorded in accrued expenses and other liabilities on our consolidated balance sheets. We received 25 repurchase requests during the three months ended March 31, 2015 and we repurchased one loan

during that period, which we expect to be purchased by the

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 15. Commitments and Contingencies - (continued)

loan originator with no resulting loss. During the three months ended March 31, 2015 and 2014 we recorded repurchase provisions of less than \$1 million, that were recorded in mortgage banking activities and MSR income on our consolidated statements of income and did not charge-off any amounts to the reserve in either period.

Loss Contingencies — Litigation

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the “FHLB-Seattle”) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (“SRF”), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the “FHLB-Seattle Defendants”) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Seattle Certificate”) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the “2005-4 RMBS”) and purchased by the FHLB-Seattle.

Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys’ fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, as of March 31, 2015, the FHLB-Seattle has received approximately \$116 million of principal and \$11 million of interest payments in respect of the Seattle Certificate. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle’s claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (“Schwab”) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the “Schwab Defendants”) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. Schwab alleged only a claim for negligent misrepresentation under California state law against SRF and sought unspecified damages and attorneys’ fees and costs from SRF. Schwab claims that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Schwab Certificate”) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. On November 14, 2014, Schwab voluntarily dismissed with prejudice its negligent misrepresentation claim, which resulted in the dismissal with prejudice of SRF from the action. The Schwab Certificate was issued with an original principal amount of approximately \$15 million, and, as of March 31, 2015, approximately \$13 million of principal and \$1 million of interest payments have been made in respect of the Schwab Certificate. we agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named and remain as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At March 31, 2015, the aggregate amount of loss contingency reserves established in respect of the FHLB-Seattle and Schwab litigation matters described above was \$2 million. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 15. Commitments and Contingencies - (continued)

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

Note 16. Equity

The following table provides a summary of changes to accumulated other comprehensive income by component for the three months ended March 31, 2015 and 2014.

Changes in Accumulated Other Comprehensive Income by Component

(In Thousands)	Three Months Ended March 31, 2015		Three Months Ended March 31, 2014	
	Net unrealized gains on available-for-sale securities	Net unrealized losses on interest rate agreements accounted for as cash flow hedges	Net unrealized gains on available-for-sale securities	Net unrealized losses on interest rate agreements accounted for as cash flow hedges
Balance at beginning of period	\$ 186,737	\$(46,049)	\$ 164,654	\$(15,888)
Other comprehensive income (loss) before reclassifications	5,053	(8,442)	19,323	(8,795)
Amounts reclassified from other accumulated comprehensive income	(1,690)	) 31	1,298	60
Net current-period other comprehensive income (loss)	3,363	(8,411)) 20,621	(8,735)
Balance at End of Period	\$ 190,100	\$(54,460)) \$ 185,275	\$(24,623)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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March 31, 2015

(Unaudited)

Note 16. Equity - (continued)

The following table provides a summary of reclassifications out of accumulated other comprehensive income for three months ended March 31, 2015 and 2014.

Reclassifications Out of Accumulated Other Comprehensive Income

(In Thousands)	Affected Line Item in the Income Statement	Amount Reclassified From Accumulated Other Comprehensive Income Three Months Ended March 31,	
		2015	2014
Net realized gains (losses) on AFS securities			
Other than temporary impairment	Other market valuations, net	\$—	\$1,298
Gain on sale of AFS securities	Realized gains, net	\$(1,690)) \$—
		\$(1,690)	) \$1,298
Net realized gains on interest rate agreements designated as cash flow hedges			
Amortization of deferred loss	Interest expense	\$31	\$60
		\$31	\$60

Earnings Per Common Share

The following table provides the basic and diluted earnings per common share computations for the three months ended March 31, 2015 and 2014.

Basic and Diluted Earnings Per Common Share

(In Thousands, Except Share Data)	Three Months Ended March 31,	
	2015	2014
Basic Earnings Per Common Share:		
Net income attributable to Redwood	\$14,801	\$12,333
Less: Dividends and undistributed earnings allocated to participating securities	(822)	) (702)
Net income allocated to common shareholders	\$13,979	\$11,631
Basic weighted average common shares outstanding	83,360,312	82,410,562
Basic Earnings Per Common Share	\$0.17	\$0.14
Diluted Earnings Per Common Share:		
Net income attributable to Redwood	\$14,801	\$12,333
Less: Dividends and undistributed earnings allocated to participating securities	(822)	) (702)
Net income allocated to common shareholders	\$13,979	\$11,631
Weighted average common shares outstanding	83,360,312	82,410,562
Net effect of dilutive equity awards	2,261,904	2,529,978
Diluted weighted average common shares outstanding	85,622,216	84,940,540
Diluted Earnings Per Common Share	\$0.16	\$0.14

For the three months ended March 31, 2015 and 2014, we determined certain equity awards outstanding during each of these periods qualified as participating securities. We included participating securities in the calculation of basic earnings per common share as well as diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method. For the three months ended March 31, 2015 and 2014, there were 2,261,904 and 2,529,978 of dilutive equity awards, respectively,

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(Unaudited)

Note 16. Equity - (continued)

determined under the two-class method. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances.

For the three months ended March 31, 2015 and 2014, 21,292,309 and 11,825,450, respectively, of common shares related to the assumed conversion of the convertible notes were antidilutive and were excluded in the calculation of diluted earnings per share. For the three months ended March 31, 2014, the number of outstanding equity awards that were antidilutive totaled 79,535.

Stock Repurchases

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the three months ended March 31, 2015, there were no shares acquired under the plan. At March 31, 2015, there remained 4,005,985 shares available for repurchase under this plan.

Note 17. Equity Compensation Plans

At March 31, 2015 and December 31, 2014, 1,914,207 and 2,225,245 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled \$25 million at March 31, 2015, as shown in the following table.

(In Thousands)	Three Months Ended March 31, 2015				
	Restricted Stock	Deferred Stock Units	Performance Stock Units	Employee Stock Purchase Plan	Total
Unrecognized compensation cost at beginning of period	\$ 1,091	\$ 12,304	\$ 6,874	\$ —	\$ 20,269
Equity grants	2,636	5,162	—	236	8,034
Equity grant forfeitures	(162)	) —	—	—	(162)
Equity compensation expense	(250)	) (1,575)	) (854)	) (59)	) (2,738)
Unrecognized Compensation Cost at End of Period	\$ 3,315	\$ 15,891	\$ 6,020	\$ 177	\$ 25,403

At March 31, 2015, the weighted average amortization period remaining for all of our equity awards was less than two years.

Restricted Stock

At March 31, 2015 and December 31, 2014, there were 196,644 and 109,464 shares, respectively, of restricted stock awards outstanding. Restrictions on these shares lapse through 2019. During the three months ended March 31, 2015, there were 136,561 restricted stock awards granted, 40,643 restricted stock awards that vested and were distributed, and 8,738 restricted stock awards forfeited.

Deferred Stock Units (“DSUs”)

At March 31, 2015 and December 31, 2014, there were 2,438,081 and 2,168,824 DSUs, respectively, outstanding of which 1,435,093 and 1,287,862, respectively, had vested. There were 269,258 DSUs granted, and no DSUs distributed or forfeited during the three months ended March 31, 2015. Unvested DSUs at March 31, 2015 vest through 2019.

Performance Stock Units (“PSUs”)

At both March 31, 2015 and December 31, 2014, the target number of PSUs that were unvested was 761,051. PSUs do not vest until the third anniversary of their grant date, with the level of vesting at that time contingent on total

stockholder return (defined as the change in our common stock price plus dividends paid on our common stock relative to the per share price of our common stock on the date of the PSU grant) over the three-year vesting period (“Three-Year TSR”). The number of underlying shares of our common stock that will vest during 2015 and in future years will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 17. Equity Compensation Plans - (continued)

or equal to 125%) of the target number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period.

With respect to the PSUs granted in 2011, the three-year performance period ended during the fourth quarter of 2014, resulting in the vesting of 701,440 shares of our underlying common stock. The distribution of these underlying shares of common stock will occur in May 2015, in accordance with the terms of the PSUs and our Executive Deferred Compensation Plan.

Employee Stock Purchase Plan

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. As of March 31, 2015 and December 31, 2014, 283,092 and 274,318 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP at March 31, 2015.

Note 18. Mortgage Banking Activities

The following table presents the components of mortgage banking activities, net, recorded in our consolidated income statements for the three months ended March 31, 2015 and 2014.

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Residential mortgage banking activities:		
Changes in fair value of:		
Residential loans, at fair value ⁽¹⁾	\$20,312	\$7,045
Sequoia IO securities	(14,359)	) (4,277)
Risk management derivatives ⁽²⁾	(4,371)	) (4,278)
Other ⁽³⁾	633	446
Total residential mortgage banking activities:	2,215	(1,064)
Commercial mortgage banking activities:		
Changes in fair value of:		
Commercial loans, at fair value	5,857	3,626
Risk management derivatives ⁽²⁾	(6,212)	) (2,803)
Other ⁽³⁾	63	10
Total commercial mortgage banking activities:	(292)	) 833
Mortgage banking activities	\$1,923	\$(231)

(1) Includes changes in fair value for loan purchase and forward sale commitments.

(2) Represents market valuation changes of derivatives that are used to manage risks associated with our accumulation of residential and commercial loans.

(3) Amounts in this line item include other fee income from loan acquisitions and the provision for repurchases expense, presented net.

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Note 19. Operating Expenses

Components of our operating expenses for the three months ended March 31, 2015 and 2014 are presented in the following table.

Operating Expenses

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Fixed compensation expense	\$9,155	\$6,742
Variable compensation expense	3,991	2,781
Equity compensation expense	2,738	2,330
Total compensation expense	15,884	11,853
Systems and consulting	2,122	3,466
Accounting and legal	1,577	1,633
Office costs	1,232	985
Corporate costs	526	552
Other operating expenses	3,722	1,482
Total Operating Expenses	\$25,063	\$19,971

Note 20. Taxes

For the three months ended March 31, 2015 and 2014, we recognized a benefit for income taxes of \$5 million and \$2 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at March 31, 2015 and 2014.

Reconciliation of Statutory Tax Rate to Effective Tax Rate

	March 31, 2015		March 31, 2014	
Federal statutory rate	34.0	%	34.0	%
State statutory rate, net of Federal tax effect	7.2	%	7.2	%
Differences in taxable (loss) income from GAAP income	(44.7)	)%	(1.7))%
Change in valuation allowance	11.9	%	3.7	%
Dividends paid deduction	(64.4)	)%	(60.8))%
Effective Tax Rate	(56.0)	)%	(17.6))%

The negative effective tax rate for the three months ended March 31, 2015, resulted from a benefit for income taxes being recorded against GAAP losses generated at our taxable REIT subsidiaries, while the consolidated income statement reported GAAP income. On a consolidated basis, GAAP income generated at the REIT, for which no material tax provision was recorded due to the dividends paid deduction, exceeded the losses at the taxable REIT subsidiaries.

We assessed our tax positions for all open tax years (Federal - years 2011 to 2015, State - years 2010- 2015) and, at March 31, 2015 and December 31, 2014, concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 21. Segment Information

Redwood operates in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For a full description of our segments, see Item 1—Business in our Annual Report on Form 10-K.

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

The following tables present financial information by segment for the three months ended March 31, 2015 and 2014.

Business Segment Financial Information

(In Thousands)	Three Months Ended March 31, 2015				
	Residential Mortgage Banking	Residential Investments	Commercial Mortgage Banking and Investments	Corporate/ Other	Total
Interest income	\$15,795	\$30,012	\$10,914	\$7,025	\$63,746
Interest expense	(3,778)	(2,810)	(3,489)	(13,884)	(23,961)
Net interest income (loss)	12,017	27,202	7,425	(6,859)	39,785
Provision for loan losses	—	—	(206)	—	(206)
Non-interest income					
Mortgage banking activities	2,215	—	(292)	—	1,923
MSR income (loss)	—	(10,924)	—	—	(10,924)
Other market valuation adjustments	2	(19)	—	(1,128)	(1,145)
Realized gains, net	—	4,306	—	—	4,306
Other income	—	809	—	—	809
Total non-interest income, net	2,217	(5,828)	(292)	(1,128)	(5,031)
Direct operating expenses	(10,903)	(1,118)	(3,482)	(9,560)	(25,063)
Benefit from income taxes	8	3,510	853	945	5,316
Segment Contribution	\$3,339	\$23,766	\$4,298	\$(16,602)	
Net Income					\$14,801
Non-cash amortization expense	(46)	9,838	(49)	(981)	8,762

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(Unaudited)

Note 21. Segment Information - (continued)

(In Thousands)	Three Months Ended March 31, 2014				Total
	Residential Mortgage Banking	Residential Investments	Commercial Mortgage Banking and Investments	Corporate/ Other	
Interest income	\$ 10,668	\$ 27,594	\$ 10,384	\$ 6,830	\$ 55,476
Interest expense	(1,321)	(2,850)	(3,303)	(11,586)	(19,060)
Net interest income (loss)	9,347	24,744	7,081	(4,756)	36,416
Provision for loan losses	—	—	(655)	(629)	(1,284)
Non-interest income					
Mortgage banking activities	(1,064)	—	833	—	(231)
MSR income (loss)	—	606	—	—	606
Other market valuation adjustments	(2)	(5,957)	—	(179)	(6,138)
Realized gains, net	—	987	—	105	1,092
Total non-interest income, net	(1,066)	(4,364)	833	(74)	(4,671)
Direct operating expenses	(7,094)	(1,095)	(2,626)	(9,156)	(19,971)
(Provision for) benefit from income taxes	(165)	1,527	355	126	1,843
Segment Contribution	\$ 1,022	\$ 20,812	\$ 4,988	\$ (14,489)	
Net Income					\$ 12,333

Non-cash amortization expense (52) 11,247 (173) (1,946) 9,076

The following tables present the components of Corporate/Other for the three months ended March 31, 2015 and 2014.

(In Thousands)	Three Months Ended March 31, 2015			2014		
	Legacy Consolidated VIEs	Other	Total	Legacy Consolidated VIEs	Other	Total
Interest income	\$ 7,018	\$ 7	\$ 7,025	\$ 6,828	\$ 2	\$ 6,830
Interest expense	(4,482)	(9,402)	(13,884)	(5,460)	(6,126)	(11,586)
Net interest income (loss)	2,536	(9,395)	(6,859)	1,368	(6,124)	(4,756)
Provision for loan losses	—	—	—	(629)	—	(629)
Non-interest income						
Other market valuation adjustments	(1,093)	(35)	(1,128)	(142)	(37)	(179)
Realized gains, net	—	—	—	105	—	105
Total non-interest income, net	(1,093)	(35)	(1,128)	(37)	(37)	(74)
Direct operating expenses	—	(9,560)	(9,560)	(52)	(9,104)	(9,156)
Benefit from income taxes	—	945	945	—	126	126
Total	\$ 1,443	\$ (18,045)	\$ (16,602)	\$ 650	\$ (15,139)	\$ (14,489)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2015

(Unaudited)

Note 21. Segment Information - (continued)

The following table presents supplemental information by segment at March 31, 2015 and December 31, 2014.
Supplemental Disclosures

(In Thousands)	Residential Mortgage Banking	Residential Investments	Commercial Mortgage Banking and Investments	Corporate/ Other	Total
March 31, 2015					
Residential loans	\$1,094,885	\$1,000,444	\$—	\$1,304,426	\$3,399,755
Commercial loans	—	—	460,342	—	460,342
Real estate securities	65,809	1,219,434	—	—	1,285,243
Mortgage servicing rights	—	120,324	—	—	120,324
Total assets	1,204,055	2,446,100	467,200	1,698,664	5,816,019
December 31, 2014					
Residential loans	\$1,342,519	\$581,668	\$—	\$1,474,386	\$3,398,573
Commercial loans	—	—	566,927	—	566,927
Real estate securities	93,802	1,285,428	—	—	1,379,230
Mortgage servicing rights	—	139,293	—	—	139,293
Total assets	1,468,856	2,057,256	575,943	1,816,911	5,918,966

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

INTRODUCTION

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to provide a reader of our financial statements with a narrative from the perspective of our management on our financial condition, results of operations, liquidity and certain other factors that may affect our future results. Our MD&A is presented in six main sections:

Overview

Results of Operations

Liquidity and Capital Resources

Off Balance Sheet Arrangements and Contractual Obligations

Critical Accounting Policies and Estimates

New Accounting Standards

Our MD&A should be read in conjunction with the Consolidated Financial Statements and related Notes included in Part 1, Item 1, of this Quarterly Report on Form 10-Q and in Item 8, Financial Statements in our most recent Annual Report on Form 10-K, as well as the sections entitled "Risk Factors" in Item 1A of our most recent Annual Report on Form 10-K and Part II, Item 1A of this Quarterly Report on Form 10-Q, as well as other cautionary statements and risks described elsewhere in this report and our most recent Annual Report on Form 10-K. The discussion in this financial review contains forward-looking statements that involve substantial risks and uncertainties. Our actual results could differ materially from those anticipated in these forward looking statements as a result of various factors, such as those discussed in the Cautionary Statement below.

References herein to "Redwood," the "company," "we," "us," and "our" include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in this "Management's Discussion and Analysis of Financial Condition and Results of Operations," and our consolidated financial statements and notes thereto, which are included in Part I, Item 1 of this Quarterly Report on Form 10-Q. Our website can be found at www.redwoodtrust.com. We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission ("SEC"). We also make available, free of charge, access to our charters for our Audit Committee, Compensation Committee, and Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code). In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-GAAP financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. Through the commercial section of our website, we also disclose information about our origination or acquisition of new commercial loans and other commercial investments, generally within five business days of origination or acquisition. We believe that this information may be of interest to investors in Redwood, although we may not always disclose on our website each new commercial loan or other new commercial investment we originate or acquire (or we may not disclose them on our website within the five business day period described above) due to, among other reasons, confidentiality obligations to the borrowers of those loans or counterparties to those investments. The information on our website is not part of this Quarterly Report on Form 10-Q.

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

Our Business

Redwood Trust, Inc., together with its subsidiaries, focuses on investing in mortgage- and other real estate-related assets and engaging in residential and commercial mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential and commercial mortgage banking activities. We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. A further description of our business and these segments can be found in Item 1 of our Annual Report on Form 10-K.

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Our primary sources of income are net interest income from our investment portfolios and income from our mortgage banking activities. Net interest income consists of the interest income we earn less the interest expense we incur on borrowed funds and other liabilities. Income from mortgage banking activities consists of the profit we seek to generate through the acquisition or origination of loans and their subsequent sale or securitization.

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

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

Consolidated Securitization Entities

We sponsor our Sequoia securitization program, which we use for the securitization of residential mortgage loans. We are required under Generally Accepted Accounting Principles in the United States (“GAAP”) to consolidate the assets and liabilities of certain Sequoia securitization entities we have sponsored for financial reporting purposes. However, each of these entities is independent of Redwood and of each other, and the assets and liabilities of these entities are not owned by us or legal obligations of ours, respectively, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities and, to the extent we hold securities issued by, or other investments in, these entities, we are exposed to the performance of these entities and the assets they hold. We refer to certain of these securitization entities as “consolidated Sequoia entities,” and where applicable, in analyzing our results of operations we distinguish results from current operations “at Redwood” and, from consolidated Sequoia entities. On January 1, 2015, we adopted ASU 2014-13 and began to account for residential loans held-for-investment and asset backed securities issued at consolidated Sequoia entities at fair value. See Note 3 of the Notes to our Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion. During the third quarter of 2011, we engaged in a transaction in which we resecutitized a pool of senior residential securities (the “Residential Resecutitization”) primarily for the purpose of obtaining permanent non-recourse financing on a portion of the residential securities we hold in our investment portfolio at the REIT. Similarly, during the fourth quarter of 2012, we engaged in a transaction in which we securitized a pool of commercial loans (the “Commercial Securitization”) primarily for the purpose of obtaining permanent non-recourse financing on a portion of the commercial loans we hold in our investment portfolio at the REIT. In analyzing our results of operations, the Commercial Securitization and Residential Resecutitization are included in our results at Redwood as we view these transactions as a form of financing.

Cautionary Statement

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) statements we make regarding Redwood’s business strategy and strategic focus, including statements relating to our confidence in our overall market position, strategy and long-term prospects, and our belief in the long-term efficiency of private label securitization as a form of mortgage financing; (ii) statements related to our residential mortgage banking activities, including our expectation to distribute the majority of our first quarter jumbo loan pipeline and inventory at or above our quarter-end accounting valuations during the second quarter, our belief that loan sale profit margins generated on more recent loan acquisitions will be within our long-term target range of 25 to 50 basis points, our expectations regarding the MPF Direct™ initiative created by the FHLBC, and statements related to pooling conforming loans to create tailored Agency securities that could attract higher prices from investors; (iii) statements we make regarding securitization reform, including efforts to improve structural investor protection mechanisms, our expectation to add a transaction manager in one of our upcoming Sequoia securitizations, and other incremental reforms becoming the norm in private label securitization transactions; (iv) statements we make regarding additional opportunities to

participate in risk-sharing transactions with the GSEs over the next several quarters; (v) statements we make regarding the outlook for our commercial business, including our positioning to benefit from a substantial wave of refinance opportunities and the expectation of additional demand for commercial loans beginning late in the second quarter of 2015, our exploration of ways to diversify our commercial loan distribution platform, our expectation that margins on our existing commercial loan pipeline will improve in the second quarter of 2015, and our statement that we intend to sell certain commercial senior loans into securitization transactions scheduled for the second quarter of 2015; (vi) statements relating to the effectiveness of our efforts to manage our exposure to interest-rate volatility and the tactics we employ today and in the future to manage such exposure; (vii) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase or plan to purchase, including the amount of such loans that we identified for purchase during the first quarter of 2015 and at March 31, 2015, and statements relating to expected fallout and the corresponding volume of residential mortgage loans expected to be available for purchase; (viii) statements relating to our estimate of

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our investment capacity (including that we estimate our investment capacity at March 31, 2015 to be approximately \$198 million); (ix) statements we make regarding our dividend policy, including our intention to pay a regular dividend of \$0.28 per share per quarter in 2015; and (x) statements regarding our expectations and estimates relating to the characterization for income tax purposes of our dividend distributions, our expectations and estimates relating to tax accounting, tax liabilities and tax savings, and GAAP tax provisions, our estimates of REIT taxable income and TRS taxable income, and our anticipation of additional credit losses for tax purposes in future periods (and, in particular, our statement that, for tax purposes, we expect an additional \$30 million of tax credit losses on residential securities we currently own to be realized over an estimated three- to five-year period).

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

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

OVERVIEW

Business Update

During the first quarter, we continued to face difficult market conditions, in particular from high interest rate volatility, which negatively impacted our GAAP earnings. Despite these challenges, we believe we did a good job navigating our way through these conditions and at the same time continuing to advance our residential and commercial business franchises to capitalize on opportunities we see evolving in the mortgage markets.

Similar to the fourth quarter of 2014, we believe our hedging strategies were effective in economically protecting our balance sheet against the overall decline in interest rates that occurred during the first quarter of 2015. For financial reporting purposes, however, the negative impact on our mortgage servicing rights (MSR) investments was recorded

to our income statement, reducing earnings, while an offsetting positive impact of declining interest rates on our securities investments was primarily unrealized for accounting purposes and recorded to our balance sheet.

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Market Conditions

The interest rate volatility that started late last year continued through the first quarter of 2015. The 10-year Treasury yield ranged from a low of 1.62% to a high of 2.22%, before closing at 1.92%, down 25 basis points since December 31, 2014. Interest rate volatility poses a challenge to our businesses overall, but is particularly disadvantageous for our jumbo residential and commercial mortgage banking activities. Through these mortgage banking activities, we generally commit upfront to acquire or originate loans, which we typically intend to securitize or sell. High interest rate volatility creates pricing uncertainty that generally results in senior triple-A investors and whole loan buyers demanding higher liquidity premiums (lower prices) to compensate them for the heightened uncertainty. We assume this risk as part of our business model and seek to address it prospectively by adjusting our loan acquisition and origination pricing, which we did for both businesses during the first quarter of 2015.

Residential Mortgage Banking Activities

Jumbo Loans

As a result of the challenging market conditions during the first quarter of 2015, our jumbo Sequoia securitization execution and our jumbo whole loan sales were adversely impacted. The impact was compounded as the market value data points from these transactions were used to re-value our entire jumbo residential pipeline and loan inventory at March 31, 2015.

Our jumbo mortgage banking activities are off to a good start early into the second quarter of 2015. Interest rate volatility has decreased and loan sale pricing has improved. We expect to sell the vast majority of our first quarter jumbo loan pipeline and inventory at or above our quarter-end accounting valuations. To date in the second quarter, we had new loan sales totaling \$480 million through a bulk whole loan sale and a Sequoia securitization transaction that were executed at pricing levels significantly above our March 31, 2015 accounting valuations.

In order to win back widespread confidence and participation by triple-A investors in private label residential securitization, there are several efforts afoot that have been characterized by industry participants as “RMBS 3.0.” These efforts are aimed at improving structural investor protection mechanisms in RMBS transactions, as well as adding an independent transaction manager to enhance oversight and ensure enforcement of contractual terms. We have been a leader on this initiative. Our most recent Sequoia transaction, which closed at the end of April, included a new structural feature intended to address potential conflicts relating to servicer advances, which was one of the securitization reforms we had previously proposed. We were pleased, not only with the pricing execution on this transaction, but also with the level and depth of triple-A investor interest.

We continue to listen to feedback from triple-A investors about securitization reform and we expect to add a transaction manager in one of our upcoming Sequoia securitizations (this was another reform we previously proposed). We are optimistic that as these incremental reforms become the norm, it will further strengthen the Sequoia brand, increase triple-A investor participation, and improve transaction execution.

Conforming Loans

Our conforming mortgage banking activities remain an important strategic piece of our business plan, as they enable us to generate income and create attractive servicing and credit risk investments, and provide opportunities to leverage our residential platform’s fixed costs.

In terms of market conditions, our conforming results were far less impacted by interest rate volatility during the first quarter of 2015 when compared to our jumbo results, as available hedge instruments (TBAs) are more closely correlated to the conforming loans we purchase and our inventory turns are typically faster. However, we continue to face stiff competitive pricing pressure for conforming loans, as the industry overall has still not fully downsized its excess capacity to originate new loans.

Our focus, therefore, remains on driving profitability by optimizing seller relationships, adding distribution channels, and leveraging overhead through increased loan processing efficiencies. For example, we recently achieved sufficient scale to begin pooling conforming loans for a securities execution through Fannie Mae and Freddie Mac, which will allow us to create tailored Agency securities that can attract higher prices from investors.

Currently, the bulk of our conforming investment activity is through the creation of servicing assets. We remain encouraged, however, that additional opportunities are emerging to participate in credit risk sharing transactions with the GSEs over the next several quarters, similar to the transaction we completed with Fannie Mae in the fourth quarter of 2014. These transactions serve an important purpose to the GSEs' regulator, as they can potentially help shape public policy around the eventual reform of the GSEs. From our perspective, our ability to create attractive credit investments in our conforming loan production over time will greatly complement our jumbo loan investments being created today through our Sequoia program.

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Commercial

The commercial loan market was also impacted by significant interest rate volatility during the first quarter of 2015, along with increased competition for new loans from an increasing number of lenders. Additionally, the commercial market is highly seasonal, with the first quarter typically having the lowest industry origination volume of a particular year. These market factors, combined with widening CMBS spreads, adversely impacted our first quarter mortgage banking income. Like our residential business, however, we have begun to see some positive developments since quarter-end. Our pipeline of loans under application has significantly increased and stood at approximately \$275 million at April 30, 2015, slightly above where we were last year at this time. The wave of loan maturities industry participants have been predicting for some time is expected to translate into additional loan demand beginning late in the second quarter of 2015.

Our challenge going forward is to diversify our distribution for commercial loans we originate, potentially outside of CMBS conduits. There is currently a shortage of liquidity for the subordinate “B-Piece” tranches of CMBS securitizations, resulting in significant idiosyncratic risk that loans may not be saleable into CMBS conduits for an extended period – often regardless of the credit characteristics of these loans. While our credit discipline remains unchanged, and we have sufficient balance-sheet capacity and financing in place to weather periods of market illiquidity, we continue to explore ways to diversify our commercial franchise and leverage our ability to offer attractive senior and mezzanine financing solutions to good borrowers.

Closing

Despite a challenging period for our business, we continue to believe that our residential and commercial loan platforms provide us a competitive advantage in terms of creating attractive investments while generating fee income. Our market leading jumbo platform has provided us with almost two-thirds of our current residential investments portfolio and has produced substantial fee income. Our conforming platform has provided us with attractive mortgage servicing rights and we are making good progress toward creating additional risk-sharing investments with the GSEs in the coming quarters. Finally, our commercial platform has been a capital-efficient source of fee income and diversification for our overall investment portfolio, and remains well positioned to capitalize on the expected wave of maturing commercial loans over the next few years.

Financial and Operational Overview – First Quarter of 2015

Following is a summary of our key financial and operational results for the first quarter of 2015.

We earned \$0.16 per share for the first quarter of 2015, as compared to \$0.31 per share for the fourth quarter of 2014. Earnings declined from the prior quarter primarily as a result of lower margins on jumbo loan sales as well as negative market valuation adjustments on mortgage servicing rights (MSRs) due to declining benchmark interest rates.

Our GAAP book value at March 31, 2015, was \$15.01 per share, as compared to \$15.05 per share at December 31, 2014. The decline in earnings and its impact on book value was largely offset by our cumulative hedging results – much of which was not reflected in earnings. Our March 31, 2015 book value also reflects the \$0.28 per share dividend we paid to shareholders in the first quarter.

We deployed \$133 million of capital in the first quarter of 2015, as compared to \$159 million in the fourth quarter of 2014. Over two-thirds of the new investments we recorded over these periods were created through our residential and commercial mortgage-banking operations.

Residential loans identified for purchase increased 32% to \$3.7 billion during the first quarter of 2015 compared with \$2.8 billion during the fourth quarter of 2014. At March 31, 2015, our pipeline of residential loans identified for purchase was \$1.8 billion and included \$1.4 billion of jumbo loans and \$0.4 billion of conforming loans, unadjusted for fallout expectations.

We completed one Sequoia securitization of \$339 million during the first quarter (SEMT 2015-1), and created \$8 million of new investments for our portfolio. In addition, we sold \$511 million of jumbo loans to third parties during the first quarter of 2015. Our FHLB-member subsidiary pledged \$448 million of jumbo loans to the FHLBC, investing approximately \$82 million of capital.

Total commercial loan originations were \$100 million for the first quarter of 2015 and included \$93 million of senior loans and \$8 million of mezzanine loans, as compared to \$326 million of senior loans and \$22 million of mezzanine loans for the fourth quarter of 2014. At April 30, 2015, our pipeline of senior loans (loans closed or under application) was \$275 million.

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At March 31, 2015 our GAAP book value was \$1.3 billion, or \$15.01 per share, a decrease from \$15.05 per share at December 31, 2014. The following table sets forth the changes in our GAAP book value per share for the three months ended March 31, 2015.

Table 1 – Changes in Book Value per Share

	Three Months Ended March 31, 2015
(In Dollars, per share basis)	
Beginning book value	\$ 15.05
Net income	0.16
Change in unrealized gains on securities, net	0.05
Change in unrealized losses on derivatives	(0.10)
Dividends	(0.28)
Adoption of ASU 2014-13	0.11
Other, net	0.02
Ending Book Value per Share	\$ 15.01

We believe our efforts to mitigate the impact of significant interest-rate volatility during the first quarter of 2015 were largely effective. A significant contributing factor to the \$0.04 per share decline in book value was valuation decreases from spread widening (i.e., investor demand for higher yields) on jumbo residential loans held-for-sale, which we do not hedge against. As a result, our combined earnings, changes in unrealized gains on securities, and other items did not fully offset our first quarter dividend paid to shareholders.

The remaining components of the change in book value, including the change in value of our interest rate hedges on long-term debt and the impact of our adoption of a new accounting standard for consolidated Sequoia entities, were largely offsetting. The new accounting standard allowed us to reclassify our investment in consolidated Sequoia entities from amortized cost to fair value. We believe this was a positive change, as the book value of our net equity investments in consolidated Sequoia entities at March 31, 2015, now equals the \$72 million fair value of our economic interests in those securitizations.

Our approach to managing our interest-rate exposure is dynamic and is continually adjusted to maximize its effectiveness while positioning us to still earn attractive, risk-adjusted returns. For example, during the first quarter of 2015, we maintained significant holdings of investment-grade rated “mezzanine” residential mortgage-backed securities, whose values characteristically increase as interest rates decline. These securities represented approximately two-thirds of our subordinate securities portfolio, which increased in value by \$13 million during the first quarter of 2015. The majority of this increase related to changes in the value of the mezzanine securities and resulted from interest rate changes during the quarter. Conversely, our MSR portfolio incurred negative market valuation adjustments of \$20 million during the first quarter of 2015, of which \$6 million was due to the change in the basis of our investment from the receipt of expected fees during the quarter, and \$14 million was from adverse changes in prepayment assumptions due to the effect of declining interest rates on valuations. As the changes in value of our mezzanine securities were recorded through equity on the balance sheet and the changes in value of our MSRs were recorded through the income statement, our first quarter earnings did not reflect the effectiveness of our hedging strategy.

Over time, we expect our investment-grade rated mezzanine portfolio to pay down or be sold, and we will likely transition our hedging focus to more traditional interest-rate derivatives. Although the accounting rules for such derivatives could potentially benefit our GAAP income in a particular quarter, they would come with an added economic cost in comparison to relying on offsetting positions inherent in our businesses.

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Quarterly Investment Activity

Our deployment of capital decreased only modestly in the first quarter of 2015, compared to the prior quarter. The following table details our capital invested for the first quarter of 2015 and fourth quarter of 2014.

Table 2 – Investment Activity

(In Thousands)	Three Months Ended	
	March 31, 2015	December 31, 2014
Residential		
Sequoia RMBS	\$6,276	\$24,414
Third-party RMBS	26,662	36,296
Less: Short-term debt/Other liabilities	(8,503)) —
Total RMBS	24,435	60,710
Agency risk sharing transaction	—	—
Loans, net - FHLBC ⁽¹⁾	82,204	57,014
MSR investments	18,754	19,305
Total residential	125,393	137,029
Commercial		
Mezzanine loans	7,600	21,870
Commercial B-notes	—	—
Less: Borrowings	—	—
Total commercial	7,600	21,870
Capital Invested	\$132,993	\$158,899

(1) Includes loans pledged to FHLBC and FHLBC stock acquired, less FHLBC borrowings.

Net of financing, we deployed \$133 million of capital in the first quarter, continuing our pace set in the third and fourth quarters of 2014. Notable investments in the first quarter included \$82 million of capital invested in \$448 million of loans held by our FHLB-member subsidiary and financed with advances from the FHLBC, \$19 million of investments in MSRs, and \$6 million in retained subordinate securities created from the Sequoia securitization we completed during the first quarter of 2015.

Our first quarter capital investments were partially offset by the sale of \$18 million of conforming MSRs and \$104 million of mostly Sequoia mezzanine and IO securities. After the repayment of short-term debt, these sales made available approximately \$71 million of capital for reinvestment.

Following the end of the first quarter of 2015 and through April 30, 2015, we invested \$22 million of capital including \$5 million in subordinate securities retained from our recent Sequoia securitization, \$5 million in third party securities and \$12 million in MSR investments. During the same period we sold \$43 million of Sequoia mezzanine securities, which made available approximately \$9 million of capital after the repayment of short-term debt.

Our investment portfolio increased 13% during the first quarter to \$2.74 billion at March 31, 2015, and included \$1.29 billion of securities, \$1.00 billion of loans pledged to the FHLBC, \$120 million of MSR investments, and \$338 million of commercial loans. Included in this portfolio were \$66 million of Sequoia senior and IO securities, which are included in our Residential Mortgage Banking segment for financial reporting purposes.

Residential Operations

- Our combined residential jumbo and conforming purchase volume was \$2.5 billion in the first quarter of 2015, down 10% from the fourth quarter of 2014. The decline in loan purchase volume was largely due to seasonal factors that reduced loans identified for purchase in the fourth quarter of 2014.

During the first quarter of 2015, we continued to make progress on our MPF Direct™ initiative with the FHLBC. We acquired our first loans through MPF Direct™ during the first quarter and had 10 approved sellers and approximately 100 sellers under application at March 31, 2015. Two other FHLBs (Boston and San Francisco) obtained approval from their regulator to participate in the MPF Direct™ initiative and we expect others to follow in the coming

quarters.

At March 31, 2015, we had 180 residential loan sellers, up from 169 at the end of the fourth quarter of 2014. At March 31, 2015, our residential mortgage banking operations had 102 dedicated employees, as compared to 100 at the beginning of 2015, and 60 at the beginning of 2014.

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Commercial Operations

At March 31, 2015, we held \$54 million of commercial senior loans that we intend to sell into securitization transactions scheduled for the second quarter of 2015.

At March 31, 2015, we had \$338 million of commercial mezzanine loans held-for-investment with a weighted average yield of approximately 10% and a weighted average maturity of over four years.

Capital and Liquidity

Our total capital of \$1.9 billion at March 31, 2015, included \$1.3 billion of equity capital and \$0.6 billion of our total \$1.6 billion of long-term debt. This portion of long-term debt included \$140 million of trust-preferred securities due in 2037, \$288 million of convertible debt due in 2018, and \$205 million of exchangeable debt due in 2019.

During the first quarter of 2015, the FHLBC approved an increase to our FHLB-member subsidiary's financing limit of \$500 million, bringing our subsidiary's total financing capacity with the FHLBC to \$1 billion. Our FHLB-member subsidiary borrowed an additional \$354 million of long-term debt from the FHLBC during the first quarter, which increased total long-term debt associated with FHLBC borrowings to \$851 million at March 31, 2015.

At March 31, 2015, we held \$304 million in cash, and our investment capacity (defined as the approximate amount of capital we had readily available for long-term investments) was approximately \$198 million. This amount excludes cash flow we expect to receive in future quarters from investments and cash proceeds that we could generate from the sale of non-core investments such as our mezzanine RMBS securities.

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RESULTS OF OPERATIONS

The following table presents the components of our GAAP net income for the three months ended March 31, 2015 and 2014.

Table 3 – Net Income

	Three Months Ended March 31,			
(In Thousands, Except per Share Data) ⁽¹⁾	2015	2014	Change	
Net Interest Income	39,785	36,416	3,369	
Provision for loan losses	(206	) (1,284	) 1,078
Net Interest Income After Provision	39,579	35,132	4,447	
Non-interest Income			—	
Mortgage banking activities	1,923	(231	) 2,154
MSR income (loss)	(10,924) 606	(11,530)
Other market valuation adjustments	(1,145	) (6,138	) 4,993
Realized gains, net	4,306	1,092	3,214	
Other income	809	—	809	
Total non-interest income (loss)	(5,031) (4,671) (360)
Operating expenses	(25,063) (19,971) (5,092)
Net income before provision for income taxes	9,485	10,490	(1,005)
Benefit from income taxes	5,316	1,843	3,473	
Net Income	\$14,801	\$12,333	\$2,468	
Diluted earnings per common share	\$0.16	\$0.14	\$0.02	
Net Interest Income				

The \$3 million increase in net interest income was primarily due to an increase in the average balance of loans held-for-investment and pledged with the FHLBC and an increase in the average balance of loans held-for-sale at our residential mortgage banking operations during the first quarter of 2015.

Additional detail on changes in net interest income is provided in the “Net Interest Income” section that follows.

Provision for Loan Losses

During the three months ended March 31, 2015, our provision for loan losses related entirely to our commercial loan investments. As a result of the adoption of ASU 2014-13 on January 1, 2015, we no longer have a provision for loan losses on residential loans held-for-investment at consolidated Sequoia entities as these loans are now carried at fair value.

Additional information on the adoption of ASU 2014-13 is provided in the “Results of Consolidated Sequoia Entities” section that follows.

Mortgage Banking Activities

Income from mortgage banking activities includes results from both our residential and commercial mortgage banking operations. The \$2 million increase in the first quarter of 2015 was predominately due to an increase in loan acquisition volume at our residential mortgage banking operations during the quarter, which was partially offset by lower profit margins for these operations. The increase from residential mortgage banking activities was partially offset by a decline in income from commercial mortgage banking activities, resulting from lower profit margins experienced during the first quarter of 2015.

Additional detail on our residential and commercial mortgage banking results are included in the Residential Mortgage Banking and Commercial Mortgage Banking and Investment portions of the “Results of Operations by Segment” section that follows.

MSR Income

MSR income is comprised of both the net fee income we earn from our MSR investments as well as changes in their market value. In the first quarter of 2015, MSR income was comprised of \$8 million of net fee income and \$20 million of negative market valuation changes, as compared to \$3 million in net fee income and \$3 million of negative market valuation changes in the first quarter of 2014.

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The negative market valuation changes in the first quarter of 2015 included \$5 million from the realization of expected servicing income and \$14 million from the adverse effect to valuations of declining mortgage interest rates during the first quarter of 2015.

Additional detail on our investment in MSRs is included in the Residential Investments portion of the “Results of Operations by Segment” section that follows.

Other Market Valuation Adjustments

For the three months ended March 31, 2015, other market valuation adjustments included negative \$1 million attributable to declines in the value of derivatives used to manage risks associated with certain of our residential investment securities. Changes in the value of the securities being hedged by these derivatives were recorded in other comprehensive income on our balance sheet and were not recognized in net income. Additional negative adjustments of \$2 million in the three months ended March 31, 2015, relate to a combination of a decline in value of our risk share investment and changes in the fair value of our investments in consolidated Sequoia entities. The negative valuation adjustments were offset by a \$2 million increase in the value of loans held-for-investment and pledged with the FHLBC.

For the three months ended March 31, 2014, we recorded negative \$6 million of other market valuation adjustments, the majority of which was attributable to declines in the values of derivatives used to manage risks associated with certain residential investments on our balance sheet. These derivatives declined in value as a result of declining rates during that quarter.

Realized Gains, Net

Realized gains, net, were \$4 million for the three months ended March 31, 2015, and primarily resulted from the sale of \$91 million of available-for-sale securities. The amount of the gains or losses in a period depends on several factors, including the amount of sales and the unrealized gain or loss on the securities prior to sale.

For additional detail on realized gains, see the Residential Investments portion of the “Results of Operations by Segment” section that follows.

Operating Expenses

During the first quarter of 2015, operating expenses increased to \$25 million, as compared to \$20 million in the first quarter of 2014. The increase was primarily due to an increase in compensation expenses related to the expansion of our residential mortgage banking operations. At March 31, 2015 we had 232 employees, as compared to 156 employees at March 31, 2014.

Other Income

Other income was \$1 million for the three months ended March 31, 2015, and included income from fees generated from our risk sharing investment as well as the amortization of our guarantee liability associated with this transaction.

Provision for Income Taxes

We recorded a benefit from income taxes of \$5 million in the first quarter of 2015, as compared to a benefit from income taxes of \$2 million in the first quarter of 2014. Our provision for income taxes is primarily driven by activity at our taxable REIT subsidiaries, which includes our residential and commercial mortgage banking activities and MSR investments. The benefit from income taxes in the first quarters of 2015 and 2014 resulted from GAAP losses generated at our taxable REIT subsidiaries, primarily due to losses incurred on our MSR investments.

For additional detail on income taxes, see the “Taxable Income” section that follows.

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Net Interest Income

The following tables present the components of net interest income for the three months ended March 31, 2015 and 2014.

Table 4 – Net Interest Income

(Dollars in Thousands)	Three Months Ended March 31, 2015				2014			
	Interest Income/(Expense)	Average Balance ⁽¹⁾	Yield		Interest Income/(Expense)	Average Balance ⁽¹⁾	Yield	
Interest Income								
Residential loans, held-for-sale	\$ 11,469	\$ 1,292,153	3.6	%	\$ 5,830	\$ 518,054	4.5	%
Residential loans - held-for-investment	6,522	667,543	3.9	%	—	—	—	%
Residential loans - Sequoia ⁽²⁾	7,018	1,362,612	2.1	%	6,828	1,711,438	1.6	%
Commercial loans - held-for-sale	1,186	137,977	3.4	%	1,100	68,169	6.5	%
Commercial loans - held-for-investment ⁽³⁾	9,728	407,482	9.5	%	9,284	364,331	10.2	%
Trading securities	5,258	111,408	18.9	%	5,734	123,190	18.6	%
Available-for-sale securities	22,517	1,058,036	8.5	%	26,697	1,396,831	7.7	%
Other interest income	48	232,575	0.1	%	3	159,089	—	%
Total interest income	63,746	5,269,786	4.8	%	55,476	4,341,102	5.1	%
Interest Expense								
Short-term debt	(7,224)	1,590,179	(1.8)	%	(3,827)	1,006,349	(1.5)	%
ABS issued - Redwood	(1,720)	117,950	(5.8)	%	(2,981)	230,172	(5.2)	%
ABS issued - Sequoia ⁽²⁾	(4,482)	1,295,852	(1.4)	%	(5,460)	1,644,626	(1.3)	%
Long-term debt	(10,535)	1,245,612	(3.4)	%	(6,792)	480,362	(5.7)	%
Total interest expense	(23,961)	4,249,593	(2.3)	%	(19,060)	3,361,509	(2.3)	%
Net Interest Income	\$ 39,785				\$ 36,416			

(1) Average balances for residential and commercial loans held-for-sale and trading securities are calculated based upon carrying values, which represent estimated fair values. Average balances for available-for-sale securities and debt are calculated based upon amortized historical cost except for ABS issued-Sequoia, which is based upon fair value.

(2) The interest income from residential loans held-for-investment - Sequoia and the interest expense from ABS issued - Sequoia represent activity from our consolidated Sequoia entities.

(3) Excluding A-notes sold, but accounted for as secured borrowings, the yield on commercial loans held-for-investment was 10.5% and 10.8% for the three months ended March 31, 2015 and 2014, respectively.

The following tables present the components of net interest income for the three months ended March 31, 2015 and 2014.

Table 5– Net Interest Income by Segment

(In Thousands)	Three Months Ended March 31,		
	2015	2014	Change
Net interest income by Segment			
Residential Mortgage Banking	\$ 12,017	\$ 9,347	\$ 2,670
Residential Investments	27,202	24,744	2,458
Commercial Mortgage Banking and Investments	7,425	7,081	344
Corporate/Other	(6,859)	(4,756)	(2,103)
Net Interest Income	\$ 39,785	\$ 36,416	\$ 3,369

Analysis of Changes in Net Interest Income

The \$3 million increase in net interest income from our residential mortgage banking segment primarily resulted from a higher average balance of loans held-for-sale during the first quarter of 2015, which was partially offset by lower

yields. The higher loan balances were primarily due to increases in conforming loan purchases, which increased significantly as we expanded that aspect of our business.

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The \$2 million increase in net interest income from our residential investments segment primarily resulted from a \$6 million increase in net interest income from residential loans held-for-investment and financed with FHLBC borrowings during the last nine months. This increase was partially offset by a \$4 million decrease from lower average balances of available-for-sale securities as sales and paydowns outpaced new security investments.

Our commercial mortgage banking and investments segment contributed less than \$1 million of the increase in overall net interest income, primarily resulting from lower outstanding balances of ABS issued, which has decreased as loans in our Commercial Securitization paid-down.

Additional details regarding the activities impacting net interest income at each segment are included in the “Results of Operations by Segment” section that follows.

The corporate/other line item includes interest expense related to long-term debt not directly allocated to our segments and net interest income from consolidated Sequoia entities. Interest expense from long-term debt not directly allocated to our segments was \$9 million and \$6 million during the first quarters of 2015 and 2014, respectively, with the increase attributable to the exchangeable debt issued by a taxable subsidiary of ours in November 2014. Contributions to net interest income from consolidated Sequoia entities were \$3 million and \$1 million in the first quarters of 2015 and 2014, respectively. Additional details regarding consolidated Sequoia entities are included in the “Results from Consolidated Sequoia Entities” section that follows.

The following table presents the net interest rate spread between the yield on unsecuritized loans and securities and the debt yield of the short-term debt used in part to finance each investment type at March 31, 2015.

Table 6 – Interest Expense — Specific Borrowing Costs

March 31, 2015	Residential Loans		Commercial Loans		Residential Securities	
Asset yield	3.78	%	8.99	%	6.86	%
Short-term debt yield	1.74	%	4.40	%	1.38	%
Net spread	2.04	%	4.59	%	5.48	%

For additional discussion on short-term debt, including information regarding margin requirements and financial covenants, see “Risks Relating to Debt Incurred Under Short-Term and Long-Term Borrowing Facilities” in the Liquidity and Capital Resources section of this MD&A.

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Results of Operations by Segment

The following is a discussion of the results of operations for our three business segments for the three months ended March 31, 2015 and 2014. For additional information on our segments, refer to Note 21 in Part I, Item I of this Quarterly Report on Form 10 Q.

Residential Mortgage Banking Segment

The following table presents the components of segment contribution for the residential mortgage banking segment for the three months ended March 31, 2015 and 2014.

Table 7 – Residential Mortgage Banking Segment Contribution

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Interest income	\$15,795	\$10,668
Interest expense	(3,778)	(1,321)
Net interest income	12,017	9,347
Mortgage banking activities	2,215	(1,064)
Other market valuation adjustments	2	(2)
Direct operating expenses	(10,903)	(7,094)
Segment contributions before income taxes	3,331	1,187
Benefit from (provision for) income taxes	8	(165)
Segment Contribution	\$3,339	\$1,022

The following table provides the activity of unsecuritized residential loans during the three months ended March 31, 2015 and 2014.

Table 8 – Residential Loans Held-for-Sale — Activity

(In Thousands)	Three Months Ended March 31, 2015			March 31, 2014		
	Jumbo	Conforming	Total	Jumbo	Conforming	Total
Balance at beginning of period	\$1,097,805	\$244,716	\$1,342,521	\$392,765	\$11,502	\$404,267
Acquisitions	1,112,493	1,365,151	2,477,644	794,031	298,940	1,092,971
Sales	(857,858)	(1,407,541)	(2,265,399)	(562,038)	(160,365)	(722,403)
Transfers between portfolios (1)	(447,840)	—	(447,840)	—	—	—
Principal repayments	(13,932)	(167)	(14,099)	(7,019)	(5)	(7,024)
Changes in fair value, net	3,348	(1,290)	2,058	7,447	(322)	7,125
Balance at End of Period	\$894,016	\$200,869	\$1,094,885	\$625,186	\$149,750	\$774,936

During the three months ended March 31, 2015, we transferred loans with a principal balance of \$436 million and (1) a fair value of \$448 million from held-for-sale to held-for-investment and moved these loans into our residential investments segment.

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The following table provides the activity of our retained Sequoia IO securities for the three months ended March 31, 2015 and 2014.

Table 9 – Sequoia Securities Activity

(In Thousands)	Three Months Ended March 31,	
	2015	2014
Beginning fair value	\$93,802	\$110,505
Acquisitions	—	—
Sales	(13,588) —
Effect of principal payments ⁽¹⁾	(98) —
Change in fair value, net	(14,307	) (4,277
Ending Fair Value ⁽²⁾	\$65,809	\$106,228

The effect of principal payments reflects the change in fair value due to principal payments, which is calculated as (1) the cash principal received on a given security during the period multiplied by the prior quarter ending price or acquisition price of the security.

(2) At March 31, 2015, balance includes \$62 million of IO senior Sequoia securities and \$4 million of non-IO senior Sequoia securities carried at fair value.

Overview

During the first quarter of 2015, we purchased \$2.5 billion of prime residential loans, and sold \$1.4 billion of conforming loans to Fannie Mae and Freddie Mac (the "Agencies") and \$511 million of jumbo loans to third parties. In addition, we securitized \$348 million of jumbo loans as part of a Sequoia securitization that settled during the first quarter. In association with these sales and securitizations, during the first quarter of 2015, we retained \$6 million of Sequoia subordinate securities and \$16 million of MSR investments. We also transferred \$448 million of loans to our residential investments segment and financed them with borrowings from the FHLBC. Our pipeline of loans identified for purchase at March 31, 2015, included \$1.37 billion of jumbo loans and \$426 million of conforming loans (unadjusted for expected fallout).

Segment contribution from residential mortgage banking increased \$2 million to \$3 million in the first quarter of 2015, as compared to the first quarter of 2014, primarily due to higher conforming loan acquisition volumes, which resulted in a \$3 million increase in net interest income and a \$3 million increase in income from mortgage banking activities. This increase was partially offset by an increase in direct operating expenses due to a combination of the higher loan purchase volume and higher personnel costs as we increased our headcount for our conforming loan business activities to 102 at March 31, 2015 from 60 at the beginning of 2014. All residential mortgage banking activities are performed in taxable subsidiaries and the provision for income taxes generally changes in relation to the amount of income earned at this segment; however, this may not always be the case due to expenses allocated to specific TRS entities that are eliminated in consolidation, but not eliminated for tax provision calculation purposes.

Net Interest Income