REDWOOD TRUST INC
Form 10-Q
August 05, 2009

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

FORM 10-Q

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

For the Quarterly Period Ended: June 30, 2009

OR

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

For the Transition Period from to

Commission File Number 1-13759

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

Not Applicable

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

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

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

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

Common Stock, $0.01 par value per share	77,651,881 shares outstanding as of August 4, 2009

Not Applicable

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REDWOOD TRUST, INC.

2009 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data) (Unaudited)	June 30, 2009	December 31, 2008
ASSETS		
Real estate loans	$3,965,782	$4,659,336
Real estate securities, at fair value:		
Trading securities	253,040	339,654
Available-for-sale securities	551,513	232,470
Total real estate securities	804,553	572,124
Other investments	46,612	78,244
Cash and cash equivalents	337,075	126,480
Total earning assets	5,154,022	5,436,184
Restricted cash	66,224	53,608
Accrued interest receivable	22,272	31,415
Derivative assets	9,290	3,071
Deferred tax asset	2,283	3,608
Deferred asset-backed securities issuance costs	7,949	9,921
Other assets	23,054	43,942
Total Assets	$5,285,094	$5,581,749
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$	$
Accrued interest payable	10,468	29,417
Derivative liabilities	113,607	177,590
Accrued expenses and other liabilities	42,398	20,118
Dividends payable	19,376	25,103
Asset-backed securities issued Sequoia	3,842,638	4,508,127
Asset-backed securities issued Acacia	286,943	346,931
Long-term debt	150,000	150,000
Total liabilities	4,465,430	5,257,286
EQUITY		
Stockholders Equity		
Common stock, par value $0.01 per share, 100,000,000 and 75,000,000 shares authorized; 77,503,470 and 33,470,557 issued and oustanding	775	335
Additional paid-in capital	1,673,655	1,149,393
Accumulated other comprehensive loss	(77,944)	(56,865)

Cumulative earnings	298,797	266,059
Cumulative distributions to stockholders	(1,093,488)	(1,057,070)
Total stockholders equity	801,795	301,852
Noncontrolling interest	17,869	22,611
Total equity	819,664	324,463
Total Liabilities and Equity	$5,285,094	$5,581,749

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(In Thousands, Except Share Data)	Three Months Ended June 30,		Six Months Ended June 30,	
(Unaudited)	2009	2008	2009	2008
Interest Income				
Real estate loans	$30,614	$72,762	$64,583	$168,386
Real estate securities	43,475	61,529	90,737	138,057
Other investments	55	514	131	1,246
Cash and cash equivalents	117	2,196	247	5,377
Total interest income	74,261	137,001	155,698	313,066
Interest Expense				
Short-term debt		(68)		(250)
Asset-backed securities issued	(37,499)	(95,205)	(83,332)	(219,790)
Long-term debt	(1,502)	(2,233)	(3,310)	(4,766)
Total interest expense	(39,001)	(97,506)	(86,642)	(224,806)
Net Interest Income	35,260	39,495	69,056	88,260
Provision for loan losses	(14,545)	(10,061)	(30,577)	(18,119)
Market valuation adjustments on trading instruments	4,102	(31,526)	(10,107)	(81,358)
Other-than-tempory impairments[1]	(33,237)	(28,970)	(62,272)	(173,067)
Market valuation adjustments, net	(29,135)	(60,496)	(72,379)	(254,425)
Net Interest Loss After Provision and Market Valuation Adjustments	(8,420)	(31,062)	(33,900)	(184,284)
Operating expenses	(10,769)	(14,255)	(21,308)	(30,604)
Realized gains, net	25,525	2,714	25,988	2,753
Net income (loss) before provision for income taxes	6,336	(42,603)	(29,220)	(212,135)
Provision for (benefit from) income taxes	514	(937)	409	(2,737)
Net income (loss)	6,850	(43,540)	(28,811)	(214,872)
Less: Net income (loss) attributable to noncontrolling interest	127	2,369	(589)	2,624
Net Income (Loss) Attributable to Redwood Trust, Inc.	$6,723	$(45,909)	$(28,222)	$(217,496)
Basic earnings (loss) per share:	$0.10	$(1.40)	$(0.48)	$(6.65)
Diluted earnings (loss) per share:	$0.10	$(1.40)	$(0.48)	$(6.65)
Regular dividends declared per common share	$0.25	$0.75	$0.50	$1.50
Basic weighted average shares outstanding	65,697,887	32,871,442	59,137,864	32,691,444
Diluted weighted average shares outstanding	66,446,025	32,871,442	59,137,864	32,691,444

(1)

For the three months ended June 30, 2009, total other-than-temporary impairments were $40,099 of which $6,862 were recognized in Accumulated Other Comprehensive Loss (Income).

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EQUITY AND COMPREHENSIVE (LOSS) INCOME

For the Six Months Ended June 30, 2009

For the Six Months Ended June 30, 2008

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) (Unaudited)	Six Months Ended June 30, 2009	2008
Cash Flows From Operating Activities:		
Net (loss) income	$(28,222)	$(217,496)
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs, net	3,493	(5,405)
Depreciation and amortization of non-financial assets	539	536
Provision for loan losses	30,577	18,119
Non-cash equity award compensation	4,156	7,038
Market valuation adjustments, net	72,379	254,425
Realized gains, net	(25,988)	(2,753)
Net change in:		
Accrued interest receivable	9,738	15,581
Deferred tax asset	1,325	788
Other assets	30,193	11,585
Accrued interest payable	(11,549)	(18,302)
Accrued expenses and other liabilities	22,280	(1,575)
Net cash provided by operating activities	108,921	62,541
Cash Flows From Investing Activities:		
Principal payments on real estate loans held-for-investment	199,516	765,293
Purchases of real estate securities available-for-sale	(438,669)	(244,252)
Proceeds from sales of real estate securities available-for-sale	57,898	7,300
Principal payments on real estate securities available-for-sale	52,372	41,098
Purchases of real estate securities trading		(3,341)
Proceeds from sales of real estate securities trading		454
Principal payments on real estate securities trading	50,942	100,504
Principal payments on other investments	14,279	541
Net (increase) decrease in restricted cash	(12,616)	15,893
Net cash (used in) provided by investing activities	(76,278)	683,490
Cash Flows From Financing Activities:		
Net borrowings on short-term debt		1,765
Repayments on asset-backed securities	(271,626)	(905,000)
Net settlements of interest rate agreements	(24,702)	(5,743)
Net proceeds from issuance of common stock	520,546	24,490
Dividends paid	(42,147)	(50,850)
Change in noncontrolling interests	(4,119)	46,583
Net cash provided by (used in) financing activities	177,952	(888,755)
Net increase (decrease) in cash and cash equivalents	210,595	(142,724)

Cash and cash equivalents at beginning of period	126,480	290,363
Cash and cash equivalents at end of period	$337,075	$147,639
Supplemental Disclosures:		
Cash paid for interest	$105,591	$243,109
Cash (received) paid for taxes	$(3,421)	$(1,442)
Dividends declared but not paid at end of period	$19,376	$24,887

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 1. Redwood Trust

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

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2009 and December 31, 2008, and for the three and six months ended June 30, 2009 and 2008. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States for interim financial information and with the Securities and Exchange Commission s (SEC) instructions to Form 10-Q and Article 10 of Regulation S-X. Results for the three and six months ended June 30, 2009, may not necessarily be indicative of the results for the year ending December 31, 2009. The unaudited interim consolidated financial statements as of June 30, 2009, should be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2008. All amounts presented herein, except per share data, are shown in thousands.

Organization

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

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

Principles of Consolidation

We apply the principles of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140) and Financial Accounting Standards Board (FASB) Interpretation No. 46 (revised), *Consolidation of Variable Interest Entities* (FIN 46(R)) to determine whether we must consolidate any entities where we have continuing involvement. We do not service any assets, including assets owned at the Fund, Sequoia, or Acacia.

We consolidate the assets, liabilities, and noncontrolling interests of the Fund that we sponsor, as we are the primary beneficiary of this entity as defined by FIN 46(R). The primary beneficiary is the party that absorbs the majority of a variable interest entity s (VIEs) anticipated losses and/or the majority of the expected returns. Our significant limited partnership interest and ongoing asset management responsibilities constitute this majority.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2009
(Unaudited)

Note 2. Basis of Presentation (continued)

We consolidate most of the assets and liabilities of the Sequoia and Acacia securitization entities that we sponsor that were not accounted for as sales. These entities did not meet the criteria for sale accounting as prescribed by FAS 140 at the time we transferred financial assets to them. Our continuing involvement includes our retention of junior interests and call rights and certain ongoing management responsibilities or other discretionary activities. For financial reporting purposes, the underlying loans and securities owned at Sequoia and Acacia entities are shown on our consolidated balance sheets under real estate loans and real estate securities, and the asset-back securities (ABS) issued to third parties are shown under ABS issued. In our consolidated statements of income (loss), we record interest income on the loans and securities owned by Sequoia and Acacia and interest expense on the ABS issued by these consolidated securitization entities.

During the second quarter of 2009, we derecognized the assets and liabilities of one Sequoia entity due to a sale of our variable interests in this entity and lack of continuing involvement. These assets and liabilities are no longer shown on our consolidated balance sheet as of June 30, 2009.

See *Note 6* for further discussion on our sale of Sequoia interests and resulting deconsolidation.

Note 3. Summary of Significant Accounting Policies

Use of Estimates

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

Fair Value Option

Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FAS No. 115* (FAS 159) gives us the option of electing to measure eligible financial assets, financial liabilities, and commitments at fair value on an instrument-by-instrument basis. This election is available when we first recognize a financial asset or financial liability or enter into a firm commitment, or upon the initial adoption of FAS 159 on January 1, 2008. Subsequent changes in the fair value of these assets, liabilities, and commitments are recorded in the consolidated statements of income (loss).

Our decision to adopt FAS 159 for new financial instruments is generally based upon our funding strategy for the specific financial asset acquired. For example, securities that we anticipate funding with equity will generally be accounted for as available-for-sale (AFS) securities under FAS 115. Securities that we anticipate funding with a combination of debt and equity or those financed through the issuance of asset-backed liabilities will generally be accounted for at fair value under FAS 159 along with the corresponding liabilities.

See *Note 4* for further discussion on the fair value option.

Fair Value Measurements

Our financial statements include assets and liabilities that are measured at their estimated fair values. We estimate fair values in accordance with Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157). Under this standard, a fair value measurement represents the price at which a

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

transaction would occur between market participants. This price implies an orderly transaction, or exit price, that is not a forced liquidation or distressed sale at the measurement date. We develop fair values for financial assets or liabilities based on available inputs and pricing that is observed in the marketplace. Examples of market information that we attempt to obtain include the following:

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

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

The markets for the real estate securities that we invest in and issue are generally illiquid. Establishing fair values for illiquid assets and liabilities is inherently subjective and is often dependent upon our estimates and modeling assumptions. If we determine that either the volume and/or level of trading activity for an asset or liability has significantly decreased from normal conditions for that asset or liability, or price quotations or observable inputs are not associated with orderly transactions, the market inputs that we obtain might not be relevant. For example, broker (or pricing service) quotes may not be relevant if an active market does not exist for the financial asset or liability. The nature of the quote (for example, whether the quote is an indicative price or a binding offer) must also be evaluated. In circumstances where relevant market inputs cannot be obtained, increased analysis and management judgment are required to estimate fair value. This may require the use of our internal assumptions about future cash flows and appropriate risk-adjusted discount rates. Regardless of the valuation inputs we apply, the objective of fair value measurement is unchanged from what it would be if markets were operating at normal activity levels and/or transactions were orderly; that is, to determine the current exit price.

In the second quarter of 2009, we adopted FASB Staff Position FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP 157-4). This FSP provides additional guidance on estimating fair value when the volume and level of trading activity for an asset or liability has significantly decreased, and determining when a transaction is not orderly. The adoption of this standard did not have a material impact on our consolidated financial position and results of operations, as our existing process is consistent with the FASB s clarification.

In the second quarter of 2009, FASB issued FASB Staff Position FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP 107-1), which expanded the annual fair value disclosures required for all financial instruments within the scope of FAS 107 to interim periods. The FSP also required publicly traded companies to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments in financial statements on an interim basis and to highlight any changes of the methods and significant assumptions from prior periods. The implementation of this standard did not have a material impact on our consolidated financial position and results of operations as our existing disclosures are consistent with the FASB s clarification.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2009
(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

Real Estate Loans

Residential and Commercial Real Estate Loans Fair Value

Residential and commercial real estate loans at fair value are loans where we have elected the fair value option under FAS 159. The fair value option was elected on January 1, 2008, for all the loans owned by Acacia securitization entities as of that date. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income (loss) in market valuation adjustments, net.

Residential and Commercial Real Estate Loans Held-for-Sale

Residential and commercial real estate loans held-for-sale are loans that we are marketing for sale to independent third parties. These loans are carried at the lower of their cost or fair value in accordance with Statement of Financial Accounting Standards No. 65, *Accounting for Certain Mortgage Banking Activities* (FAS 65), as measured on an individual basis. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. If fair value is lower than amortized cost, changes in fair value are reported through our consolidated statements of income (loss) in market valuation adjustments, net.

Residential and Commercial Real Estate Loans Held-for-Investment

Real estate loans held-for-investment include residential real estate loans owned and securitized at Sequoia entities and commercial real estate loans owned at Redwood. These loans are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Interest previously accrued for loans that have become greater than 90 days past due is reserved for in the allowance for loan losses. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due is used to reduce the outstanding loan principal balance. Pursuant to Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (FAS 91), we use the interest method to determine an effective yield and to amortize the premium or discount on real estate loans held-for-investment. For residential loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For residential loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

We may exercise our right to call ABS issued by Sequoia and may subsequently sell the underlying loans to third parties. We reclassify held-for-investment loans to held-for-sale loans if we determine that loans will be sold to third parties. Gains or losses on the sale of real estate loans are based on the specific identification method.

Real Estate Loans   Allowance for Loan Losses

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

We follow the guidelines of SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation* (SAB 102), Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), in setting the allowance for loan losses.

We consider the following factors in making such determinations:

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

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

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

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

Real Estate Securities, at Fair Value

Trading Securities

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

We primarily denote trading securities as those securities where we have adopted the fair value option under FAS 159. We currently account for certain securities at Redwood and all securities at Acacia entities as trading securities. Prior to the adoption of FAS 159, these securities were accounted for in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115).

Available-for-Sale Securities

AFS securities include certain residential, commercial, and CDO securities. AFS securities are carried at their estimated fair values with cumulative unrealized gains and losses reported as a component of accumulated other comprehensive (loss) income in our consolidated statements of equity, in accordance with FAS 115. We currently account for most securities at Redwood and all securities at the Fund as AFS securities.

When recognizing revenue on our AFS securities, we have determined that credit risk is not remote and therefore employ the interest method as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). Coupon interest is recognized as interest income when earned and deemed collectible, and the interest method is used to determine an effective yield to amortize purchase premiums, discounts, and fees associated with these securities into income over time. This requires us to project cash flows over the remaining life of each asset, which includes assumptions about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review and make adjustments to our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience. Actual maturities of our AFS securities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of AFS securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than ten years. There can be no assurance that our assumptions used to estimate future cash flows or the current period s yield for each asset will not change in the near term, and the change could be material.

Yields recognized for each security can vary as a function of credit results, prepayment rates, and interest rates. If estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected for assets acquired at a discount to face value), the yield over the remaining life of the security may be adjusted upwards. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected for assets acquired at a discount to face value), the yield over the remaining life of the security may be adjusted downward.

Every quarter we assess whether a decline in the fair value of an AFS security below our cost is an other-than-temporary impairment (OTTI). In the second quarter of 2009, we adopted FASB Staff Position FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP 115-2), which establishes a new method of recognizing and reporting OTTI of debt securities, as well as additional disclosure requirements related to debt and equity securities. Prior to the effective date of this FSP 115-2 (April 1, 2009), OTTI was based on a market value decline below a security s cost basis and a corresponding adverse change in expected future cash flows due to credit related factors, as defined by EITF 99-20. OTTI was also evaluated based on whether an entity could assert the ability and intent to hold the investment until a recovery of fair value. If the entity could not make this assertion, the cost basis of the security was written down to current fair value, with the entire write-down recognized in current earnings.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Under FSP 115-2, the determination of OTTI for debt securities has changed. The presence of OTTI continues to be based upon a market value decline below a security s cost basis and a corresponding adverse change in expected future cash flows. A change from prior guidance, FSP 115-2 considers any adverse changes in cash flows, including non-credit factors such as changes in floating interest rates. This FSP also modifies the ability and intent provision and requires impairment to be considered other-than-temporary if an entity (i) intends to sell the security, (ii) will more likely than not be required to the sell the security before it recovers in value, or (iii) does not expect to recover the security s amortized cost basis, even if the entity does not intend to sell the security. Under these scenarios, the impairment is other-than-temporary and the full amount of impairment should be recognized currently in earnings. However, if an entity does not intend to sell the impaired debt security and it is more likely than not that it will not be required to sell before recovery, the OTTI should be separated into (i) the estimated amount relating to credit loss (credit component), and (ii) the amount relating to all other factors (non-credit component). Only the estimated credit loss amount is recognized currently in earnings, with the remainder of the loss amount recognized in other comprehensive income.

Upon adoption of this FSP, we recorded a cumulative effect transition adjustment of $61 million to reclassify the non-credit portion of any OTTI previously recorded through earnings to accumulated other comprehensive (loss) income for investments held as of the beginning of the period of adoption. The cumulative effect adjustment was determined based on the difference between the present value of the cash flows expected to be collected and the amortized cost basis of the debt security as of the beginning of the period of adoption and included any related tax effects. The difference between the new amortized cost basis and the cash flows expected to be collected is accreted as interest income in accordance with the existing guidance of EITF 99-20.

In April 2009, the SEC issued Staff Accounting Bulletin 111, *Other than Temporary Impairment of Certain Investments in Equity Securities* (SAB 111), which amends SAB 59 to exclude OTTI on debt securities from its scope. The SEC issued SAB 111 to align its guidance with that of the FASB and FSP 115-2, ensuring consistency in standards for determining impairments. Our adoption of SAB 111 occurred in conjunction with our adoption of FSP 115-2.

See *Note 8* for further discussion on real estate securities and cumulative effect adjustment related to FSP 115-2.

Other Investments

Other investments include a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial statements purposes. We elected the fair value option under FAS 159 for this investment on January 1, 2008, and it is recorded on our consolidated balance sheets at its estimated fair value. Changes in fair value are reported through our consolidated statements of income (loss) through market valuation adjustments, net. Interest income is reported through our consolidated statements of income (loss) through interest income, other investments.

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

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash on hand and highly liquid investments with original maturities of three months or less. At June 30, 2009, we did not have any significant concentrations of credit risk arising from cash deposits as all of our cash and cash equivalents were invested in U.S. Government Treasury Bills or FDIC-insured bank products.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Restricted Cash

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued consolidated securitization entities, and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization entities or in the Fund prior to the purchase of loans or securities, payments on or redemption of outstanding ABS issued, or distributions to limited partners.

Accrued Interest Receivable

Accrued interest receivable represents interest that is due and payable to us. Cash interest is generally received within thirty days of recording the receivable. For financial assets where we have elected the fair value option under FAS 159, the associated accrued interest on these assets is measured at fair value. For financial assets where we have not elected to adopt FAS 159, the associated accrued interest carrying values approximate fair values.

Derivative Financial Instruments

Derivative financial instruments include contractual interest rate agreements and credit default swaps. All derivative financial instruments are reported at fair value on our consolidated balance sheets, in accordance with Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133) and FAS 159. Derivatives with a positive value to us are reported as an asset and derivatives with a negative value to us are reported as a liability. The changes in fair value of derivatives accounted for as trading instruments are reported in the consolidated statements of income (loss) through market valuation adjustments, net.

Interest Rate Agreements

We maintain an overall interest rate risk management strategy that incorporates the use of interest rate agreements. We enter into interest rate agreements for a variety of reasons, including minimizing significant fluctuations in earnings or market values on certain assets or liabilities that may be caused by interest rate volatility. Interest rate agreements that we use as part of our interest rate risk management strategy may include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchases.

Prior to 2008, we accounted for derivatives used to hedge interest rate exposure in Acacia securitization entities as cash flow hedges. At January 1, 2008, all of our consolidated derivatives designated as cash flow hedges were de-designated and accounted for as trading instruments. To the extent the associated hedged items continue to exist, the fair value of cash flow hedges at the time of de-designation remains in accumulated other comprehensive loss and is amortized using the straight-line method through interest expense over the remaining lives of the hedged Acacia ABS issued. Net purchases and proceeds from interest rate agreements are classified as financing activities within our consolidated statements of cash flows.

Credit Derivatives

A credit default swap (CDS) is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. These instruments enable us to synthetically assume the credit risk of a reference security or index of securities. All of our existing CDS contracts were initiated during 2007 by one of the Acacia entities that we have consolidated for financial reporting purposes. Net purchases and proceeds from CDS are classified as financing activities within our consolidated statements of cash flows.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Deferred Tax Assets

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

Deferred Asset-Backed Securities Issuance Costs

ABS issuance costs are costs associated with the issuance of ABS from the Sequoia securitization entities we sponsor. These costs typically include underwriting, rating agency, legal, accounting, and other fees. ABS issuance costs associated with liabilities accounted for under the fair value option are expensed as incurred. ABS issuance costs associated with liabilities reported at cost are deferred. Deferred ABS issuance costs are reported on our consolidated balance sheets as deferred charges and are amortized as an adjustment to interest expense using the interest method, based upon the actual and estimated repayment schedules of the related ABS issued under the principles prescribed in Accounting Practice Bulletin 21, *Interest on Receivables and Payables* (APB 21). Sequoia deferred ABS issuance costs are accounted for in accordance with APB 21.

As of January 1, 2008, deferred issuance costs associated with Acacia securitizations were included as part of our adoption of FAS 159 for assets and liabilities at Acacia. As a result, these deferred costs were charged to retained earnings as a part of a one-time cumulative effect adjustment on January 1, 2008.

Other Assets

Other assets on our consolidated balance sheets include real estate owned (REO), fixed assets, purchased interest, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair value. All other assets are reported at cost.

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

Short-Term Debt

Short-term debt can include master repurchase agreements, bank borrowings, and other forms of collateralized borrowings with various commercial banks and investment banks that expire within one year. These facilities may be unsecured or collateralized by loans or securities. Since November 2008 we have had no short-term debt outstanding.

Accrued Interest Payable

Accrued interest payable represents interest that is due and payable to third parties. Interest is generally paid within thirty days to three months of recording the payable, based upon our remittance requirements. For borrowings where we have elected the fair value option under FAS 159, the associated accrued interest on these liabilities is measured at fair value. For financial liabilities where we have not elected to adopt FAS 159, the associated accrued interest carrying values approximate fair values.

Asset Backed Securities Issued   Sequoia and Acacia

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote securitization entities sponsored by Redwood.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Sequoia and Acacia assets are held in the custody of trustees. These trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the ABS investors. ABS obligations are payable solely from the assets of these entities and are not obligations of Redwood.

Sequoia ABS Issued

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

Acacia ABS Issued

Effective January 1, 2008, Acacia ABS issued are accounted for under FAS 159 and carried at their estimated fair values on our consolidated balance sheets. Changes in fair value (gains or losses) are reported in our consolidated statements of income (loss) through market valuation adjustments, net. Prior to January 1, 2008, Acacia ABS issued were accounted for under the same method as Sequoia ABS issued.

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

Long-Term Debt

Long-term debt includes trust preferred securities and subordinated notes at Redwood and is carried at its unpaid principal balance. Both are unsecured debt, requiring quarterly interest payments at a floating rate equal to the three-month London Interbank Offered Rate (LIBOR) plus a margin until they are redeemed in whole or mature at a future date. These notes contain an earlier optional redemption date without penalty.

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

Equity

Earnings (Loss) Per Share

Basic earnings (loss) per share (EPS) are computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted (loss) EPS are computed by dividing net income (loss) by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares outstanding are calculated using the treasury stock method, which assumes that all dilutive common stock equivalents are exercised and the funds generated by the exercises are used to buy back outstanding common stock at the average market price of the common stock during the reporting period. In accordance with Statement of Financial Accounting Standards No. 128, *Earnings per Share* (FAS 128), if there is a loss from continuing operations, the common stock equivalents are deemed antidilutive and diluted income (loss) per share is calculated in the same manner as basic income (loss) per share.

On January 1, 2009, we adopted, FASB Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (EITF 03-6-1). EITF 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities as defined in EITF 03-6, *Participating Securities and the Two-Class Method under FASB Statement No. 128* (EITF 03-6), and therefore should be included in computing EPS using the two-class method. Our adoption of EITF 03-6-1 required us to recast previously reported EPS and did not have a significant impact on EPS.

Other Comprehensive (Loss) Income

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements previously designated as cash flow hedges under FAS 133 are reported as components of other comprehensive (loss) income on our consolidated statements of equity and comprehensive (loss) income. Net unrealized gains

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive (loss) income are adjusted for the effects of taxation and may create deferred tax assets or liabilities.

Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership interests in the Fund held by third parties. In accordance with Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (FAS 160), the noncontrolling interest of the Fund is shown as a component of equity on our consolidated balance sheets, and the portion of income allocable to third parties is shown as net income attributable to noncontrolling interest in our consolidated statements of income (loss). A reconciliation of equity attributable to noncontrolling interest is disclosed in our consolidated statements of equity and comprehensive (loss) income.

Equity Compensation Plans

Incentive Plan

In March 2008, we amended our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. This amendment was approved by our shareholders in May 2008. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock options (ISOs), non-qualifying stock options (NQSOs), deferred stock units (DSUs), restricted stock, performance shares, performance units (including cash), stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

The cost of equity awards is determined in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (FAS 123R), and amortized over the vesting term using an accelerated method in accordance with FASB Interpretation No. 28 *Accounting for Stock Appreciation Rights and Other Variable Stock Options or Award Plans* (FIN 28) and FAS 123R for equity awards granted prior to December 2008. For all equity awards granted in December 2008 and all future equity award grants, the cost of these awards will be amortized over the vesting period on a straight-line basis. Timing differences between the accelerated and straight-line method of amortization were determined to be immaterial to our financial statements.

Employee Stock Purchase Plan

In May 2002, our stockholders approved our 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP), effective July 1, 2002. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in Redwood through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter. This plan was amended by our stockholders in May 2009 to increase the number of available shares.

Executive Deferred Compensation Plan

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2009
(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. To qualify as a REIT we must distribute at least 90% of our annual REIT taxable income to shareholders (not including taxable income retained in our taxable subsidiaries) within the time frame set forth in the tax code and also meet certain other requirements. Beginning in 2003, we elected to retain up to 10% of our REIT ordinary taxable income and had provisioned for corporate income taxes on the retained income while maintaining our REIT status. In August 2008, our Board of Directors decided to distribute as dividends 100% of our REIT taxable income generated in 2007 and 2008 and our tax provisions changed accordingly.

We assess our tax positions for all open tax years and determine whether we have any material unrecognized liabilities in accordance with Financial Accounting Standard Board Interpretation Number 48, *Accounting for Uncertainty in Income Taxes*, (FIN 48). We record these liabilities to the extent we deem them incurred. We classify interest and penalties on material uncertain tax positions as interest expense and operating expense, respectively, in our consolidated statements of income (loss).

See *Note 18* for further discussion on taxes.

Recent Accounting Pronouncements

In May 2009, the FASB issued Statement of Financial Accounting Standards No. 165, *Subsequent Events* (FAS 165), which provides guidance on management s assessment of subsequent events. FAS 165 represents the inclusion of guidance on subsequent events in the accounting literature and is directed specifically to management, as management is responsible for preparing an entity s financial statements. FAS 165 is not expected to significantly change practice as its guidance is similar to that in auditing standards, with some important modifications. FAS 165 clarifies that management must evaluate, as of each reporting period, events or transactions that occur after the balance sheet date through the date that the financial statements are issued or are available to be issued. Management must perform its assessment for both interim and annual financial reporting periods. FAS 165 is effective prospectively for interim and annual periods ending after June 15, 2009. The implementation of this standard required additional disclosures, which can be found in Note 19.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 166, A*ccounting for Transfers of Financial Assets an amendment of FASB Statement No. 140* (FAS 166). FAS 166 requires more information about transfers of financial assets, including securitization transactions, and where companies have continuing exposure to the risks related to transferred financial assets. It eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. Specifically, FAS 166 (1) requires that all arrangements made in connection with a transfer of financial assets be considered in the derecognition analysis, (2) clarifies when a transferred asset is considered legally isolated from the transferor, (3) modifies the requirements related to a transferee s ability to freely pledge or exchange transferred financial assets, and (4) provides guidance on when a portion of a financial asset can be derecognized. FAS 166 enhances information reported to users of financial statements by providing greater transparency about transfers of financial assets and a company s continuing involvement in transferred financial assets. FAS 166 is effective for financial asset transfers occurring after the beginning of an entity s first fiscal year that begins after November 15, 2009. Early adoption is prohibited. We are currently evaluating the impact of FAS 166 and have not yet determined the impact of adopting this principle. However, in considering our past transfers of financial assets to securitization entities (i.e., Sequoia and Acacia) through application of FAS 140, changes to the consolidation criteria prescribed by FAS 166 for similar transfers could have a significant impact on our reported results in the future.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)*, (FAS 167), which amends the consolidation guidance that applies to VIEs. The amendment changes how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity s purpose and design and a company s ability to direct the activities of the entity that most significantly impact the entity s economic performance. Accordingly, an enterprise will need to carefully reconsider its previous FIN 46(R) conclusions, including (1) whether an entity is a VIE, (2) whether the enterprise is the VIE s primary beneficiary, and (3) what type of financial statement disclosures are required. FAS 167 will require a company to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A company will be required to disclose how its involvement with a variable interest entity affects the company s financial statements. FAS 167 is effective as of the beginning of the first fiscal year that begins after November 15, 2009. Early adoption is prohibited. We are currently evaluating the impact of FAS 167 and have not yet determined the impact of adopting this principle. However, given our previous reliance on qualifying special purpose entity (QSPE) designations for third party securitization trusts for which we have invested in, the required reconsideration of our variable interests in those trusts as of January 1, 2010, could have a significant impact on our financial statements. For example, we may determine that we are the primary beneficiary of securitization trusts that we had considered QSPEs in the past and would therefore be required to consolidate those VIEs for financial reporting purposes beginning in 2010.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162* (FAS 168) which stabilizes the Accounting Standards Codification (Codification) as the single source of authoritative GAAP in the United States. The current GAAP hierarchy consists of four levels of authoritative accounting and reporting guidance (levels A through D), including original pronouncements of the FASB, EITF abstracts, and other accounting literature (pre-Codification GAAP or current GAAP). The Codification eliminates this hierarchy and replaces current GAAP (other than rules and interpretive releases of the SEC), as used by all nongovernmental entities, with just two levels of literature: authoritative and nonauthoritative. FAS 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. Adoption of this standard may constitute a change in the way we reference current GAAP literature, but we do not anticipate adoption of FAS 168 to have a material effect on our consolidated financial statements.

Note 4. Fair Value Option

We adopted FAS 159 on January 1, 2008, and elected to apply the fair value option for the assets (loans, securities, and unamortized deferred ABS issuance costs) and liabilities (ABS issued) of our consolidated Acacia securitization entities. We also elected the fair value option for certain securities at Redwood that we anticipated potentially selling or securitizing in the future. The election of FAS 159 resulted in a $1.5 billion cumulative effect transition adjustment at January 1, 2008. There was no deferred tax impact associated with the adoption since the net unrealized losses in accumulated other comprehensive loss that were reclassified to retained earnings were generated at the REIT, which distributes predominantly all of its taxable income.

As of June 30, 2009, the loans at Acacia had an aggregate fair value of $8 million and an unpaid principal balance of $26 million, the securities had an aggregate fair value of $249 million and face value of $2.8 billion, and asset-backed securities issued at Acacia had an aggregate fair value of $287 million and an unpaid principal balance of $3.1 billion.

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Note 4. Fair Value Option (continued)

We have not elected the fair value option for any financial instruments that were acquired from third parties subsequent to our initial adoption of FAS 159 on January 1, 2008. We did elect the fair value option for certain ABS issued by Sequoia and acquired by Acacia as a result of the deconsolidation of certain Sequoia entities during the fourth quarter of 2008 and second quarter of 2009. These ABS issued had been previously eliminated as intercompany assets for financial reporting purposes.

Note 5. Fair Value of Financial Instruments

FAS 157 defines fair value, establishes a hierarchy of information used in measuring fair value, and enhances the disclosure of information about fair value measurements. FAS 157 provides that the exit price should be used to value an asset or liability, which is the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale at the measurement date. FAS 157 also provides that relevant market data, to the extent available, and not internally generated or entity specific information, should be used to determine fair value.

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value as of June 30, 2009 and December 31, 2008.

(In Thousands)	June 30, 2009 Carrying Value	Fair Value	December 31, 2008 Carrying Value	Fair Value
Assets				
Real estate loans (held-for-investment)	$ 3,955,630	$ 2,795,033	$ 4,644,735	$ 2,618,323
Real estate loans (held-for-sale)	2,337	2,337	2,624	2,624
Real estate loans (fair value)	7,815	7,815	11,977	11,977
Trading securities	253,040	253,040	339,654	339,654
Available-for-sale securities	551,513	551,513	232,470	232,470
Other investments	46,612	46,612	78,244	78,244
Cash and equivalents	337,075	337,075	126,480	126,480
Restricted cash	66,224	66,224	53,608	53,608
Accrued interest receivable	22,272	22,272	31,415	31,415
Derivative assets	9,290	9,290	3,071	3,071
REO (included in other assets)	12,335	12,335	19,264	19,264
Liabilities				

Short-term debt				
Accrued interest payable	10,468	10,468	29,417	29,417
Derivative liabilities	113,607	113,607	177,590	177,590
ABS Issued				
ABS issued Sequoia	3,842,638	2,656,571	4,508,127	2,967,763
ABS issued Acacia	286,943	286,943	346,931	346,931
Total ABS issued	4,129,581	2,943,514	4,855,058	3,314,694
Long-term debt	150,000	51,000	150,000	41,628

FAS 157 requires us to estimate and disclose fair values based on the following three-level hierarchy that prioritizes market inputs.

Level 1: Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

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Note 5. Fair Value of Financial Instruments (continued)

Level 2: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable market data.

Level 3: Unobservable inputs (e.g., an entity s own data or assumptions).

Level 3 inputs include unobservable inputs that are used when there is little, if any, market activity for the asset or liability measured at fair value. In certain cases, the inputs used to measure fair value fall into different levels of the fair value hierarchy. In such cases, the level in which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of June 30, 2009

(In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3
Assets				
Real estate loans	$ 7,815		$	$ 7,815
Trading securities	253,040			253,040
Available-for-sale securities	551,513			551,513
Other investments	46,612		46,612	
Derivative assets	9,290		9,107	183
Liabilities				
ABS issued Acacia	286,943			286,943
Derivative liabilities	113,607		67,048	46,559

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2008

(In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3
Assets				
Real estate loans	$ 11,977		$	$ 11,977
Trading securities	339,654			339,654
Available-for-sale securities	232,470			232,470
Other investments	78,244		78,244	
Derivative assets	3,071		2,829	242
Liabilities				
ABS issued Acacia	346,931			346,931
Derivative liabilities	177,590		99,698	77,892

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents additional information about the assets and liabilities recorded at fair value on our consolidated balance sheet on a recurring basis for which Level 3 inputs were used.

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

Six Months Ended June 30, 2009 (In Thousands)	Beginning Balance 12/31/2008	Principal Paydowns	Gains (Losses) Included in Net Loss	Gains (Losses) Included in Other Comprehensive Loss	Purchases, Sales, Other Settlements and Issuances, Net	Ending Balance 6/30/2009
Assets						
Real estate loans	$11,977	$(196)	$(3,967)	$	$	$7,814
Trading securities	339,654	(50,942)	(35,185)		(487)	253,040
Available-for-sale securities	232,470	(52,372)	(58,408)	37,046	392,777	551,513
Derivative assets	242		231		(290)	183
Liabilities						
ABS issued Acacia	346,931	(64,491)	(2,897)		7,400	286,943
Derivative liabilities	77,892		(672)		(30,661)	46,559

The following table presents the portion of gains or losses included in our consolidated statement of income (loss) that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and still held at June 30, 2009 and 2008. Gains or losses incurred on assets or liabilities sold or otherwise disposed of during the three and six months ended June 30, 2009 and 2008 are not included in this presentation.

Portion of Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2009 and 2008 Included in Net Income (Loss)

(In Thousands)	Included in Net Income (Loss) Three Months Ended	Six Months Ended

	June 30, 2009	June 30, 2008	June 30, 2009	June 30, 2008
Assets				
Real estate loans	$ (1,720)	$ 112	$ (3,967)	$ (4,548)
Trading securities	11,368	(62,655)	(34,408)	(857,682)
Available-for-sale securities	(33,237)	(33,036)	(62,121)	(176,724)
Derivative assets	71	177	231	208
Liabilities				
ABS issued Acacia	28,792	4,464	(2,897)	814,305
Derivative liabilities	(401)	(2,290)	(672)	(20,099)

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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Note 5. Fair Value of Financial Instruments (continued)

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

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of June 30, 2009

June 30, 2009 (In Thousands)	Carrying Value	Fair Value Measurements Using			Gain (Loss) Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
		Level 1	Level 2	Level 3		
Assets						
Real estate loans (held-for-sale)	$ 2,337			$ 2,337	$ (56)	$ (76)
REO	12,335			12,335	(1,159)	(1,923)

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of December 31, 2008

December 31, 2008 (In Thousands)	Carrying Value	Fair Value Measurements Using			Gain (Loss) Three Months Ended June 30, 2008	Six Months Ended June 30, 2008
		Level 1	Level 2	Level 3		
Assets						
Real estate loans (held-for-sale)	$ 2,624			$ 2,624	$ (81)	$ (376)
REO	19,264			19,264	(984)	(1,548)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income (loss) for the three and six months ended June 30, 2009 and 2008.

Market Valuation Adjustments, Net

(In Thousands)	Three Months Ended June 30, 2009	2008	Six Months Ended June 30, 2009	2008
Assets				
Real estate loans (fair value)	$ (1,720)	$ 112	$ (3,967)	$ (4,548)
Real estate loans (held-for-sale)	(1,215)	(1,065)	(2,000)	(1,924)
Trading securities	11,240	(65,776)	(35,185)	(863,754)
Impairments on AFS securities	(33,237)	(28,970)	(62,272)	(173,067)
Liabilities				
ABS issued Acacia	(28,792)	4,464	2,897	814,305
Derivative instruments, net	24,589	30,739	28,148	(25,437)
Market Valuation Adjustments, Net	$ (29,135)	$ (60,496)	$ (72,379)	$ (254,425)

A description of the instruments measured at fair value under FAS 157 as well as the general classification of such instruments pursuant to the valuation hierarchy described above under FAS 157 is listed below.

Real estate loans

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

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NOTES TO FINANCIAL STATEMENTS
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Note 5. Fair Value of Financial Instruments (continued)

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

Real estate securities

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

Other investments

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

Derivative assets and liabilities

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

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

Short-term debt

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

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Note 5. Fair Value of Financial Instruments (continued)

ABS issued

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

Long-term debt

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

REO

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

Note 6. Real Estate Loans

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

The following table summarizes the classifications and carrying value of the residential and commercial real estate loans reported on our consolidated balance sheets at June 30, 2009 and December 31, 2008.

(In Thousands)	June 30, 2009	December 31, 2008
Residential real estate loans (held-for-sale)	$ 2,337	$ 2,624
Residential real estate loans (held-for-investment)	3,955,383	4,644,486
Commercial real estate loans (fair value)	7,815	11,977
Commercial real estate loans (held-for-investment)	247	249
Total Real Estate Loans	$ 3,965,782	$ 4,659,336

Residential Real Estate Loans Held-for-Sale

Residential real estate loans held-for-sale are owned with equity. At June 30, 2009, there were 14 residential loans held-for-sale with $4 million in outstanding principal value and a lower of cost or fair value of $2 million. At December 31, 2008, there were 15 residential loans held-for-sale with $5 million in outstanding principal value and a lower of cost or fair value of $3 million.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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(Unaudited)

Note 6. Real Estate Loans (continued)

Residential Real Estate Loans Held-for-Investment

Residential real estate loans held-for-investment are owned at Sequoia entities that we consolidate for financial reporting purposes. The following table provides additional information on residential real estate loans held-for-investment at June 30, 2009 and December 31, 2008.

Residential Real Estate Loans Held-for-Investment

(In Thousands)	June 30, 2009	December 31, 2008
Principal value	$3,944,224	$4,612,564
Unamortized premium, net	57,036	67,635
Allowance for loan losses	(45,877)	(35,713)
Carrying Value	$3,955,383	$4,644,486

Of the $3.9 billion of principal face and $57 million of unamortized premium on these loans at June 30, 2009, $1.9 billion of principal face and $38 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. During the first half of 2009, 5% of these residential loans prepaid and we amortized 21% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal face was $2.0 billion and the unamortized premium was $19 million at June 30, 2009. During the first half of 2009, 5% of these residential loans prepaid and we amortized 8% of the premium.

Of the $4.6 billion of principal face and $68 million of unamortized premium on these loans at December 31, 2008, $2.0 billion of principal face and $48 million of unamortized premium relates to residential loans acquired prior to July 1, 2004, and $2.6 billion of principal face and $20 million of unamortized premium relates to residential loans acquired after July 1, 2004.

Sale of Sequoia Interests and Resulting Deconsolidation

During the second quarter of 2009, we sold variable interests in a Sequoia securitization issued during 2006 and determined upon completion of a FAS 140 and FIN 46(R) accounting analysis that we should derecognize the associated assets and liabilities for financial reporting purposes. We deconsolidated $439 million of real estate loans and other assets and $458 million of ABS issued and other liabilities, for a net realized gain of $19 million. We maintained our intent to hold our economic interests in all remaining consolidated Sequoia entities at June 30, 2009.

Commercial Real Estate Loans at Fair Value

Commercial real estate loans at fair value are owned at Acacia entities that we consolidate for financial reporting purposes. On January 1, 2008, we elected the fair value option under FAS 159 for loans at Acacia and record them at their estimated fair values. Prior to 2008, these loans were classified as held-for-investment. At June 30, 2009, there were five commercial loans at fair value, one of which has been delinquent since May 2009, with an outstanding principal value of $26 million and a fair value of $8 million.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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(Unaudited)

Note 6. Real Estate Loans (continued)

Commercial Real Estate Loans Held-for-Investment

Commercial real estate loans held-for-investment are owned with equity. The following table provides additional information on commercial real estate loans held-for-investment as of June 30, 2009 and December 31, 2008.

Commercial Real Estate Loans Held-for-Investment

(In Thousands)	June 30, 2009	December 31, 2008
Principal value	$ 11,094	$ 11,098
Unamortized discount	(358)	(360)
Discount designated as credit reserve	(8,141)	(8,141)
Allowance for loan losses	(2,348)	(2,348)
Carrying Value	$ 247	$ 249

At June 30, 2009, there were two commercial loans held-for-investment with $11 million in outstanding principal value and a carrying value of $0.2 million. During the first quarter of 2007, we fully reserved for an anticipated loss on a $10 million mezzanine commercial loan, which was originated to finance a condominium-conversion project. We do not expect to recover any outstanding principal upon completion and sale of the condominium units, and thus maintained the reserve as of June 30, 2009.

Note 7. Allowance for Loan Losses

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

Activity in the Allowance for Losses on Residential Loans

At June 30, 2009 and December 31, 2008, all residential loans classified as held-for-investment were owned by Sequoia entities. The following table summarizes the activity in the allowance for loan losses on residential loans held-for-investment for the three and six months ended June 30, 2009 and 2008.

(In Thousands)	Three Months Ended June 30, 2009	2008	Six Months Ended June 30, 2009	2008
Balance at beginning of period	$ 47,947	$ 24,444	$ 35,713	$ 18,282
Charge-offs, net	(1,820)	(1,908)	(5,618)	(3,804)
Provision for credit losses	14,545	10,061	30,577	18,119
Deconsolidation adjustment	(14,795)		(14,795)	
Balance at End of Period	$ 45,877	$ 32,597	$ 45,877	$ 32,597

Serious delinquencies on consolidated Sequoia loans were $141 million and $118 million as of June 30, 2009 and 2008, respectively. Serious delinquencies include loans delinquent more than 90 days and in foreclosure. As a percentage of current loan balances, serious delinquencies were 3.57% and 1.87% at June 30, 2009 and 2008, respectively.

When foreclosure is pursued in full satisfaction for a defaulted loan, we estimate the specific loan loss, if any, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest and other costs), and charge this specific estimated loss against the allowance for loan losses. During the first half of 2009, there were $6 million of charge-offs that reduced our allowance for loan losses. These charge-offs arose from $23 million of defaulted loan principal. Foreclosed property is subsequently recorded as REO, a

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 7. Allowance for Loan Losses (continued)

component of other assets. Subsequent declines in the value of an REO property below its cost basis are recorded in our consolidated statements of income (loss) as a component of market valuation adjustments, net. We had $2 million of negative market valuation adjustments during the first half of 2009 stemming from a decrease in the fair value of REO.

Activity in the Allowance for Losses on Commercial Loans

There was no activity in the allowance for loan losses for our commercial loans for the three and six months ended June 30, 2009 and 2008.

Note 8. Real Estate Securities

We invest in third party residential, commercial, and CDO securities. The following table presents the fair values of our real estate securities by collateral type and entity as of June 30, 2009 and December 31, 2008.

June 30, 2009 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	$ 499,496	$ 31,493	$ 193,481	$ 724,470
Commercial	15,669		41,949	57,618
CDO	2,308	6,358	13,799	22,465
Total Real Estate Securities	$ 517,473	$ 37,851	$ 249,229	$ 804,553

December 31, 2008 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	$ 144,885	$ 36,172	$ 244,523	$ 425,580
Commercial	42,490		67,889	110,379
CDO	3,610	11,318	21,237	36,165
Total Real Estate Securities	$ 190,985	$ 47,490	$ 333,649	$ 572,124

The following table presents our securities by trading and AFS, collateral type, and entity as of June 30, 2009 and December 31, 2008.

June 30, 2009	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$	$ 3,594	$ 3,594	$ 183,467	$	$ 183,467
Residential non-prime	697	85,236	85,933	230,258	23,001	253,259
Commercial		8,000	8,000			
Total Senior Securities	697	96,830	97,527	413,725	23,001	436,726
Re-REMIC Securities				55,141		55,141
Subordinate Securities						
Residential prime	600	34,320	34,920	26,141		26,141
Residential non-prime	231	70,332	70,563	2,961	8,492	11,453
Commercial		33,948	33,948	15,669		15,669
CDO	2,283	13,799	16,082	25	6,358	6,383
Total Subordinate Securities	3,114	152,399	155,513	44,796	14,850	59,646
Total Real Estate Securities	$ 3,811	$ 249,229	$ 253,040	$ 513,662	$ 37,851	$ 551,513

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Note 8. Real Estate Securities (continued)

December 31, 2008	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$ 60	$ 11,934	$ 11,994	$ 50,904	$	$ 50,904
Residential non-prime	905	90,638	91,543	41,915	26,531	68,446
Commercial		7,540	7,540			
Total Senior Securities	965	110,112	111,077	92,819	26,531	119,350
Subordinate Securities						
Residential prime	1,141	44,983	46,124	42,646		42,646
Residential non-prime	314	96,968	97,282	7,000	9,641	16,641
Commercial		60,349	60,349	42,490		42,490
CDO	3,585	21,237	24,822	25	11,318	11,343
Total Subordinate Securities	5,040	223,537	228,577	92,161	20,959	113,120
Total Real Estate Securities	$ 6,005	$ 333,649	$ 339,654	$ 184,980	$ 47,490	$ 232,470

Senior interests are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Re-REMIC interests, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. Re-REMIC interests are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate interests (generally originally rated AA and lower) are all interests below senior and re-REMIC interests. At June 30, 2009 all of our real estate securities had contractual maturities of over ten years, except for less than $1 million of residential securities that had contractual maturities of greater than 5 years, but less than 10 years.

AFS Securities

When we purchase a credit-sensitive AFS security at a significant discount to its face value, we often do not amortize into income a significant portion of this discount that we are entitled to earn but 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. The amount of principal face that we do not amortize into income is designated as a credit reserve on the security, with any remaining net unamortized discounts or premiums amortized into income over time using the interest method in accordance with EITF 99-20.

The following table presents the carrying value (which equals fair value) of AFS securities as of June 30, 2009 and December 31, 2008.

June 30, 2009 (In Thousands)	Residential	Commercial	CDO	Total
Current face	$ 1,599,791	$ 506,746	$ 89,289	$ 2,195,826
Credit reserve	(597,916)	(492,458)	(86,996)	(1,177,370)
Net unamortized (discount) premium	(413,539)	(121)	8,332	(405,328)
Amortized cost	588,336	14,167	10,625	613,128
Gross unrealized gains	26,591	1,502	25	28,118
Gross unrealized losses	(85,465)		(4,268)	(89,733)
Carrying Value	$ 529,462	$ 15,669	$ 6,382	$ 551,513

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 8. Real Estate Securities (continued)

December 31, 2008 (In Thousands)	Residential	Commercial	CDO	Total
Current face	$1,146,071	$514,169	$92,522	$1,752,762
Credit reserve	(731,468)	(497,047)	(59,828)	(1,288,343)
Net unamortized (discount) premium	(211,262)	35,069	(18,056)	(194,249)
Amortized cost	203,341	52,191	14,638	270,170
Gross unrealized gains	7,989	2,308	19	10,316
Gross unrealized losses	(32,693)	(12,009)	(3,314)	(48,016)
Carrying Value	$178,637	$42,490	$11,343	$232,470

The following table presents the changes for the three and six months ended June 30, 2009, of the unamortized discount and designated credit reserves on AFS securities.

Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

Three Months Ended June 30, 2009 (In Thousands)	Residential		Commercial		CDO	
	Credit Reserve	Unamortized Discount Net	Credit Reserve	Unamortized Discount Net	Credit Reserve	Unamortized Discount Net
Beginning balance March 31, 2009	$601,864	$254,228	$497,784	$(13,798)	$86,962	$(8,240)
Reclassification due to FSP 115-2 adoption		(59,949)				(1,011)
Beginning balance April 1, 2009	601,864	194,279	497,784	(13,798)	86,962	(9,251)
Amortization of net discount		(5,544)		1,788		(108)
Realized credit losses	(126,921)		(5,371)			
Acquisitions	84,033	280,795				
Sales, calls, other	(1,531)	(35,554)			34	
Impairments	20,034		12,176		1,027	
Transfers to (release of) credit reserves	20,437	(20,437)	(12,131)	12,131	(1,027)	1,027
Ending Balance June 30, 2009	$597,916	$413,539	$492,458	$121	$86,996	$(8,332)

Six Months Ended June 30, 2009 (In Thousands)	Residential Credit Reserve	Residential Unamortized Discount Net	Commercial Credit Reserve	Commercial Unamortized Discount Net	CDO Credit Reserve	CDO Unamortized Discount Net
Beginning balance December 31, 2008	$731,468	$211,262	$497,047	$(35,069)	$59,828	$18,056
Reclassification due to FSP 115-2 adoption		(59,949)				(1,011)
Amortization of net discount		(14,401)		5,838		(217)
Realized credit losses	(263,443)		(7,424)		(3,000)	
Acquisitions	84,360	338,420				
Sales, calls, other	(5,341)	(36,090)			92	
Impairments	25,169		32,187		4,916	
Transfers to (release of) credit reserves	25,703	(25,703)	(29,352)	29,352	25,160	(25,160)
Ending Balance June 30, 2009	$597,916	$413,539	$492,458	$121	$86,996	$(8,332)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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Note 8. Real Estate Securities (continued)

The loans underlying our residential subordinate securities totaled $90 billion at June 30, 2009, and consist of $81 billion prime and $9 billion non-prime loans. These loans are located nationwide with a large concentration in California (46%). Serious delinquencies (90+ days, in foreclosure or REO) at June 30, 2009 were 5.30% of current principal balances. For loans in prime pools, serious delinquencies were 3.13% of current balances. For loans in non-prime pools, serious delinquencies were 25.76% of current balances.

The loans underlying our commercial subordinate securities totaled $48 billion at June 30, 2009, and consist primarily of office (39%), retail (28%), and multifamily (16%) commercial loans. These loans are located nationwide. Serious delinquencies (60+ days and in foreclosure or REO) at June 30, 2009 were 2.48% of current principal balances.

The following table presents the components comprising the carrying value of AFS securities that were in an unrealized loss position as of June 30, 2009 and December 31, 2008.

AFS Securities with Unrealized Losses

June 30, 2009 (In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Total Amortized Cost	Gross Unrealized Losses	Total Fair Value	Total Amortized Cost	Gross Unrealized Losses	Total Fair Value
Residential	$210,906	$(69,578)	$141,328	$30,373	$(15,887)	$14,486
Commercial						
CDO	6,708	(4,268)	2,440			
Total Securities	$217,614	$(73,846)	$143,768	$30,373	$(15,887)	$14,486

December 31, 2008 (In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Total Amortized Cost	Gross Unrealized Losses	Total Fair Value	Total Amortized Cost	Gross Unrealized Losses	Total Fair Value
Residential	$100,635	$(32,693)	$67,942			
Commercial	38,001	(12,009)	25,992			
CDO	14,351	(3,314)	11,037			

Total Securities	$ 152,987	$ (48,016)	$ 104,971

Of the $90 million of unrealized losses at June 30, 2009, $20 million relates to securities owned at the Fund.

At June 30, 2009, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 596 AFS securities, of which 312 were in an unrealized loss position and 18 were in an unrealized loss position for twelve consecutive months or longer. At December 31, 2008, our consolidated balance sheet included 594 AFS securities, of which 194 were in an unrealized loss position and none were in a continuous loss position for twelve months or longer.

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NOTES TO FINANCIAL STATEMENTS June 30, 2009 (Unaudited)

Note 8. Real Estate Securities (continued)

Evaluating AFS Securities for Other-than-Temporary Impairments

On April 1, 2009, we adopted the provisions of FAS 115-2 to evaluate AFS securities for OTTI. This evaluation requires us to determine whether there has been a significant adverse quarterly change in the cash flow valuation assumptions for a security. We also consider whether there has been a significant adverse change in the regulatory and/or economic environment as part of this analysis.

The table below summarizes the significant assumptions we used to value our AFS securities as of June 30, 2009.

Significant Valuation Assumptions

June 30, 2009	Range for Securities		
	Prime	Non-prime	Commercial
Prepayment rates	4 17%	1 15%	N/A
Loss severity[1]	10 60%	20 60%	40 50%
Projected losses[1]	0 21%	1 60%	3 19%

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

For a security where an OTTI exists, and for which we do not intend to sell the security and it is more likely than not that we will not be required to sell it prior to recovery, we analyze the expected cash flows, or cost recovery, of the security and discount those cash flows to the present value (using the prior period yield for the security) to determine an expected recoverable value. The difference between this expected recoverable value and the amortized cost basis is deemed to be the credit component of OTTI that is charged to earnings. The amortized cost of the security is then adjusted to the expected recoverable value, and the difference between the expected recoverable value and fair value is deemed to be the non-credit component of OTTI that is charged to OCI, a component of stockholders equity. Future amortization and accretion for the security is computed based on the new amortized cost basis.

As part of the adoption of FSP 115-2, we evaluated $450 million of previously recorded OTTI on securities still held at April 1, 2009. Based upon the provisions of FSP 115-2, we determined that $224 million of these OTTI related to securities where we either had the intent to sell or the impairment did not include a non-credit component. The remaining $226 million of these OTTI related to securities that included a $165 million aggregate credit component and a $61 million aggregate non-credit component. We then recorded a $61 million one-time cumulative-effect adjustment to reclassify the non-credit component of these impairments previously recorded through earnings. This reclassification increased retained earnings and decreased OCI, resulting in zero net impact to our reported GAAP equity.

During the three months ended June 30, 2009, we had an additional $40 million of OTTI, of which $33 million was recognized in our consolidated statement of income (loss). Based upon the provisions of FSP 115-2, we determined that $24 million of these OTTI related to securities where we either had the intent to sell or the impairment did not include a non-credit component. The remaining $16 million of these OTTI related to securities that included a $9 million aggregate credit component and a $7 million aggregate non-credit component.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2009
(Unaudited)

Note 8. Real Estate Securities (continued)

The following table details the activity related to the credit component of OTTI (i.e., OTTI that remains in current or retained earnings) for AFS securities still held at June 30, 2009.

Activity of Credit Component of OTTI

(In Thousands)	Three Months Ended June 30, 2009
Balance at beginning of period	$
Adoption of FSP 115-2 Transition Adjustment	164,666
Current period activity:	
Additions related to AFS securities that were not previously impaired	165
Additions related to AFS securities that were previously impaired	9,281
Balance at End of Period	$ 174,112

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded to realized gains, net, in our consolidated statements of income (loss). The following table presents the gross realized gains on sales and calls of AFS securities for the three and six months ended June 30, 2009 and 2008.

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Gross realized gains sales	$ 6,861	$ 1,831	$ 7,198	$ 1,831
Gross realized gains calls				42
Gross realized losses calls		(43)		(43)
Total Realized Gains on Sales and Calls	$ 6,861	$ 1,788	$ 7,198	$ 1,830

Note 9. Other Investments

Other investments include a GIC owned by an Acacia securitization entity and recorded on our consolidated balance sheets at its estimated fair value. This GIC represents a deposit certificate issued by a rated investment bank and serves as collateral to cover realized losses on CDS entered into by this same Acacia entity. The CDS references residential mortgage-backed securities issued in 2006 that were initially A and BBB-rated. The fair value of the GIC was $47 million as of June 30, 2009, which is equal to its carrying value. The GIC has been drawn down by $33 million since its acquisition to cover credit losses and principal reductions on the referenced securities.

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NOTES TO FINANCIAL STATEMENTS
June 30, 2009
(Unaudited)

Note 10. Derivative Financial Instruments

We report our derivative financial instruments at fair value as determined using third-party models and confirmed by broker/dealers that make markets in these instruments. Our Redwood and Acacia entities hold derivative positions at June 30, 2009. Acacia s derivative financial instruments are owned by Acacia securitization entities and are not the obligation of Redwood Trust.

The following table shows the aggregate fair value and notional amount by entity of our derivative financial instruments as of June 30, 2009 and December 31, 2008.

June 30, 2009 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Interest rate caps purchased	$	$	$8,361	$710,900	$8,361	$710,900
Interest rate swaps	(1,710)	14,100	(64,409)	913,150	(66,119)	927,250
Credit default swaps			(46,559)	46,559	(46,559)	46,559
Total Derivative Financial Instruments	$(1,710)	$14,100	$(102,607)	$1,670,609	$(104,317)	$1,684,709

December 31, 2008 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Interest rate caps purchased	$	$	$1,683	$714,400	$1,683	$714,400
Interest rate caps sold	(1,084)	250,000			(1,084)	250,000
Interest rate swaps	(2,946)	14,100	(94,280)	999,681	(97,226)	1,013,781
Credit default swaps			(77,892)	78,206	(77,892)	78,206
Total Derivative Financial Instruments	$(4,030)	$264,100	$(170,489)	$1,792,287	$(174,519)	$2,056,387

Of the negative $104 million value of derivative financial instruments at June 30, 2009, $9 million was recorded as derivative assets and $114 million was recorded as derivative liabilities on our consolidated balance sheet. Of the negative $175 million value of derivative financial instruments at December 31, 2008, $3 million was recorded as derivative assets and $178 million was recorded as derivative liabilities on our consolidated balance sheet.

Interest Rate Agreements

We currently account for our interest rate agreements as trading instruments in accordance with FAS 133. Changes in the fair value of the interest rate agreements and all associated income and expenses are reported in our consolidated statements of income (loss) as a component of market valuation adjustments, net. We had net valuation adjustments on interest rate agreements of positive $24 million and $27 million for the three and six months ended June 30, 2009, respectively, and positive $33 million and negative $5 million for the three and six months ended June 30, 2008, respectively.

We did not have any interest rate agreements designated as cash flow hedges during the three and six months ended June 30, 2009. For interest rate agreements previously designated as cash flow hedges, our total unrealized loss included in accumulated other comprehensive loss was negative $25 million at June 30, 2009 and negative $27 million at December 31, 2008.

For both the three months ended June 30, 2009 and 2008, we reclassified $1 million, and for both the six months ended June 30, 2009 and 2008, we reclassified $2 million of previously designated cash flow hedges related to other comprehensive loss to interest expense.

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Note 10. Derivative Financial Instruments (continued)

Credit Derivatives

All of our existing credit default swaps (CDS) contracts were initiated during 2007 by an Acacia securitization entity that we have consolidated for financial reporting purposes. As the seller of these contracts we receive a fixed-rate premium and have assumed the credit risk of the reference securities.

These CDS are accounted for as trading instruments. The estimated fair values of these contracts fluctuate for a variety of reasons, such as the likelihood or occurrence of a specific credit event, the market perception of default risk and counterparty risk, and supply and demand changes. A qualifying credit event, defined as an interest shortfall, a failure to pay principal, or a distressed rating downgrade, may trigger Acacia as the seller of protection to compensate the counterparty (which it does so by drawing down on the GIC it owns). During the three and six months ended June 30, 2009, the reference securities underlying our CDS experienced principal losses resulting in $15 million and $32 million obligations, respectively. During both the three and six months ended June 30, 2009, the fair value of these CDS increased $1 million. During the three and six months ended June 30, 2008, the fair value of these CDS decreased $2 million and $20 million, respectively.

The following table presents the fair value of our CDS along with certain risk characteristics as of June 30, 2009 and December 31, 2008. All of these CDS have expiration dates of greater than 15 years.

(In Thousands)	June 30, 2009		December 31, 2008	
	Fair Value	Maximum Payout/ Notional Amount	Fair Value	Maximum Payout/ Notional Amount
Credit rating of referenced securities				
BB/B	$	$	$ (9,943)	$ 9,967
CCC/CC/C	(46,559)	46,559	(67,949)	68,239
Total	$ (46,559)	$ 46,559	$ (77,892)	$ 78,206

Counterparty Credit Risk

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. To mitigate this risk, we enter into agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the

Federal Reserve Bank of New York as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated A or higher. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments.

As of June 30, 2009, Redwood and its affiliates had seventeen International Swaps and Derivatives Association (ISDA) agreements with nine different bank counterparties. We had two open derivative positions at June 30, 2009, and were in compliance with our ISDA counterparty for those two positions.

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Note 11. Other Assets

Other assets as of June 30, 2009, and December 31, 2008, are summarized in the following table.

Other Assets

(In Thousands)	June 30, 2009	December 31, 2008
REO	$ 12,335	$ 19,264
Fixed assets and leasehold improvements	4,362	5,103
Principal receivable	633	1,647
Income tax receivables	2,564	4,225
Prepaid expenses	1,063	9,119
Other	2,097	4,584