

REDWOOD TRUST INC  
Form 10-Q  
November 08, 2016

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Quarterly Period Ended: September 30, 2016

OR

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

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

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

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

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

Not Applicable

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

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

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

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

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

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

Common Stock, \$0.01 par value per share 76,656,828 shares outstanding as of October 31, 2016

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2016 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)

ASSETS <sup>(1)</sup>

|   | September 30,<br>2016 | December 31,<br>2015 |
|---|-----------------------|----------------------|
| Residential loans, held-for-sale, at fair value                                 | \$ 1,188,514          | \$ 1,115,738         |
| Residential loans, held-for-investment, at fair value                           | 3,122,650             | 2,813,065            |
| Commercial loans, held-for-sale (includes \$0 and \$39,141 at fair value)       | 30,400                | 39,141               |
| Commercial loans, held-for-investment (includes \$0 and \$67,657 at fair value) | —                     | 363,506              |
| Real estate securities, at fair value   | 936,910               | 1,233,256            |
| Mortgage servicing rights, at fair value  | 106,009               | 191,976              |
| Cash and cash equivalents   | 221,372               | 220,229              |
| Total earning assets  | 5,605,855             | 5,976,911            |
| Restricted cash   | 2,044                 | 5,567                |
| Accrued interest receivable   | 20,054                | 23,290               |
| Derivative assets   | 36,880                | 16,393               |
| Other assets  | 207,786               | 197,886              |
| Total Assets  | \$ 5,872,619          | \$ 6,220,047         |

LIABILITIES AND EQUITY <sup>(1)</sup>

## Liabilities

|   |              |              |
|---|--------------|--------------|
| Short-term debt   | \$ 1,117,405 | \$ 1,855,003 |
| Accrued interest payable  | 15,518       | 8,936        |
| Derivative liabilities  | 100,117      | 62,794       |
| Accrued expenses and other liabilities  | 69,708       | 69,897       |
| Asset-backed securities issued (includes \$819,868 and \$996,820 at fair value), net <sup>(2)</sup> | 819,868      | 1,049,415    |
| Long-term debt (includes \$0 and \$63,152 at fair value), net <sup>(2)</sup>                        | 2,619,873    | 2,027,737    |
| Total liabilities   | 4,742,489    | 5,073,782    |

## Equity

|   |              |              |
|---|--------------|--------------|
| Common stock, par value \$0.01 per share, 180,000,000 shares authorized; 76,682,333 and 78,162,765 issued and outstanding | 767          | 782          |
| Additional paid-in capital  | 1,677,623    | 1,695,956    |
| Accumulated other comprehensive income  | 54,715       | 91,993       |
| Cumulative earnings   | 1,124,580    | 1,018,683    |
| Cumulative distributions to stockholders  | (1,727,555 ) | (1,661,149 ) |
| Total equity  | 1,130,130    | 1,146,265    |
| Total Liabilities and Equity  | \$ 5,872,619 | \$ 6,220,047 |

Our consolidated balance sheets include assets of consolidated variable interest entities (“VIEs”) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have (1) recourse to Redwood Trust, Inc. or its affiliates. At September 30, 2016 and December 31, 2015, assets of consolidated VIEs totaled \$847,399 and \$1,195,574, respectively. At September 30, 2016 and December 31, 2015, liabilities of consolidated VIEs totaled \$820,391 and \$1,050,861, respectively. See Note 4 for further discussion. At September 30, 2016 and December 31, 2015, Asset-backed securities issued, net included \$0 and \$542, (2) respectively, of deferred debt issuance costs, and long-term debt, net included \$7,891 and \$10,438, respectively, of deferred debt issuance costs.

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



REDWOOD TRUST, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME

| (In Thousands, except Share Data)            | Three Months Ended |            | Nine Months Ended |            |
|--|--------------------|------------|-------------------|------------|
| (Unaudited)                                  | September 30,      |            | September 30,     |            |
|  | 2016               | 2015       | 2016              | 2015       |
| Interest Income                              |                    |            |                   |            |
| Residential loans                            | \$ 35,595          | \$ 29,472  | \$ 102,149        | \$ 80,289  |
| Commercial loans                             | 6,453              | 11,191     | 28,834            | 34,784     |
| Real estate securities                       | 18,600             | 22,749     | 58,112            | 75,363     |
| Other interest income                        | 258                | 72         | 926               | 167        |
| Total interest income                        | 60,906             | 63,484     | 190,021           | 190,603    |
| Interest Expense                             |                    |            |                   |            |
| Short-term debt                              | (5,405 )           | (7,627 )   | (17,439 )         | (21,378 )  |
| Asset-backed securities issued               | (3,193 )           | (5,190 )   | (11,457 )         | (17,037 )  |
| Long-term debt                               | (12,999 )          | (11,058 )  | (39,095 )         | (32,429 )  |
| Total interest expense                       | (21,597 )          | (23,875 )  | (67,991 )         | (70,844 )  |
| Net Interest Income                          | 39,309             | 39,609     | 122,030           | 119,759    |
| Reversal of provision for loan losses        | 859                | 60         | 7,102             | 115        |
| Net Interest Income after Provision          | 40,168             | 39,669     | 129,132           | 119,874    |
| Non-interest Income (loss)                   |                    |            |                   |            |
| Mortgage banking activities, net             | 9,766              | 1,333      | 24,712            | 10,706     |
| Mortgage servicing rights income (loss), net | 3,770              | 3,549      | 12,834            | (6,545 )   |
| Investment fair value changes, net           | 11,918             | (14,169 )  | (18,686 )         | (17,105 )  |
| Other income                                 | 1,643              | 327        | 4,157             | 2,435      |
| Realized gains, net                          | 6,615              | 5,548      | 26,037            | 16,170     |
| Total non-interest income (loss), net        | 33,712             | (3,412 )   | 49,054            | 5,661      |
| Operating expenses                           | (20,355 )          | (24,497 )  | (70,962 )         | (74,778 )  |
| Net Income before Provision for Income Taxes | 53,525             | 11,760     | 107,224           | 50,757     |
| (Provision for) benefit from income taxes    | (972 )             | 7,404      | (1,327 )          | 10,272     |
| Net Income                                   | \$ 52,553          | \$ 19,164  | \$ 105,897        | \$ 61,029  |
| Basic earnings per common share              | \$ 0.67            | \$ 0.22    | \$ 1.34           | \$ 0.71    |
| Diluted earnings per common share            | \$ 0.58            | \$ 0.22    | \$ 1.23           | \$ 0.69    |
| Regular dividends declared per common share  | \$ 0.28            | \$ 0.28    | \$ 0.84           | \$ 0.84    |
| Basic weighted average shares outstanding    | 76,680,183         | 83,787,533 | 76,827,026        | 83,696,461 |
| Diluted weighted average shares outstanding  | 97,831,617         | 85,074,704 | 97,991,678        | 85,338,996 |

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

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

| (In Thousands)   | Three Months<br>Ended September<br>30, |            | Nine Months Ended<br>September 30, |           |
|--|--|------------|------------------------------------|-----------|
| (Unaudited)  | 2016                                   | 2015       | 2016                               | 2015      |
| Net Income   | \$52,553                               | \$19,164   | \$105,897                          | \$61,029  |
| Other comprehensive income (loss):   |  |            |                                    |           |
| Net unrealized gain (loss) on available-for-sale securities                        | 9,038                                  | (5,673 )   | 5,195                              | (5,701 )  |
| Reclassification of unrealized gain on available-for-sale securities to net income | (1,319 )                               | (3,270 )   | (19,983 )                          | (10,320 ) |
| Net unrealized gain (loss) on interest rate agreements                             | 647                                    | (12,049 )  | (22,545 )                          | (5,023 )  |
| Reclassification of unrealized loss on interest rate agreements to net income      | 18                                     | 19         | 55                                 | 77        |
| Total other comprehensive income (loss)  | 8,384                                  | (20,973 )  | (37,278 )                          | (20,967 ) |
| Total Comprehensive Income   | \$60,937                               | \$(1,809 ) | \$68,619                           | \$40,062  |

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

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

For the Nine Months Ended September 30, 2016

| (In Thousands, except<br>Share Data)<br>(Unaudited) | Common Stock |        | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income | Cumulative<br>Earnings | Cumulative<br>Distributions<br>to<br>Stockholders | Total        |
|---|--------------|--------|----------------------------------|---|------------------------|---|--------------|
|   | Shares       | Amount |                                  |   |                        |   |              |
| December 31, 2015                                   | 78,162,765   | \$ 782 | \$ 1,695,956                     | \$ 91,993                                       | \$ 1,018,683           | \$(1,661,149)                                     | \$ 1,146,265 |
| Net income  | —            | —      | —                                | —   | 105,897                | —   | 105,897      |
| Other comprehensive loss                            | —            | —      | —                                | (37,278 )                                       | —                      | —   | (37,278 )    |
| Employee stock purchase<br>and incentive plans      | 437,441      | 4      | (4,183 )                         | —   | —                      | —   | (4,179 )     |
| Non-cash equity award<br>compensation               | —            | —      | 10,595                           | —   | —                      | —   | 10,595       |
| Share repurchases                                   | (1,917,873 ) | (19 )  | (24,745 )                        | —   | —                      | —   | (24,764 )    |
| Common dividends<br>declared                        | —            | —      | —                                | —   | —                      | (66,406 )   | (66,406 )    |
| September 30, 2016                                  | 76,682,333   | \$ 767 | \$ 1,677,623                     | \$ 54,715                                       | \$ 1,124,580           | \$(1,727,555)                                     | \$ 1,130,130 |

For the Nine Months Ended September 30, 2015

| (In Thousands, except<br>Share Data)<br>(Unaudited)                         | Common Stock |        | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income | Cumulative<br>Earnings | Cumulative<br>Distributions<br>to<br>Stockholders | Total        |
|---|--------------|--------|----------------------------------|---|------------------------|---|--------------|
|   | Shares       | Amount |                                  |   |                        |   |              |
| December 31, 2014   | 83,443,141   | \$ 834 | \$ 1,774,030                     | \$ 140,688                                      | \$ 906,867             | \$(1,566,278)                                     | \$ 1,256,141 |
| Cumulative effect<br>adjustment - adoption of<br>ASU 2014-13 <sup>(1)</sup> | —            | —      | —                                | —   | 9,728                  | —   | 9,728        |
| January 1, 2015   | 83,443,141   | 834    | 1,774,030                        | 140,688   | 916,595                | (1,566,278 )                                      | 1,265,869    |
| Net income  | —            | —      | —                                | —   | 61,029                 | —   | 61,029       |
| Other comprehensive<br>income   | —            | —      | —                                | (20,967 )                                       | —                      | —   | (20,967 )    |
| Dividend reinvestment &<br>stock purchase plans                             | 418,508      | 4      | 6,830                            | —   | —                      | —   | 6,834        |
| Employee stock purchase<br>and incentive plans                              | 714,801      | 7      | (7,735 )                         | —   | —                      | —   | (7,728 )     |
| Non-cash equity award<br>compensation                                       | —            | —      | 9,002                            | —   | —                      | —   | 9,002        |
| Share repurchases   | (2,451,523 ) | (24 )  | (35,352 )                        | —   | —                      | —   | (35,376 )    |
| Common dividends<br>declared  | —            | —      | —                                | —   | —                      | (72,088 )   | (72,088 )    |
| September 30, 2015  | 82,124,927   | \$ 821 | \$ 1,746,775                     | \$ 119,721                                      | \$ 977,624             | \$(1,638,366)                                     | \$ 1,206,575 |

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

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





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

| (In Thousands)<br>(Unaudited)  | Nine Months Ended<br>September 30, |             |
|--|------------------------------------|-------------|
|  | 2016                               | 2015        |
| Cash Flows From Operating Activities:  |                                    |             |
| Net income   | \$105,897                          | \$61,029    |
| Adjustments to reconcile net income to net cash used in operating activities:                  |                                    |             |
| Amortization of premiums, discounts, and securities issuance costs, net                        | (20,251 )                          | (26,244 )   |
| Depreciation and amortization of non-financial assets  | 849                                | 510         |
| Purchases of held-for-sale loans   | (3,817,445)                        | (8,794,939) |
| Proceeds from sales of held-for-sale loans   | 2,930,641                          | 7,741,024   |
| Principal payments on held-for-sale loans  | 55,694                             | 46,952      |
| Net settlements of derivatives   | (13,914 )                          | (47,002 )   |
| Provision for loan losses  | (7,102 )                           | (115 )      |
| Non-cash equity award compensation expense   | 10,595                             | 9,002       |
| Market valuation adjustments   | 9,238                              | 40,546      |
| Realized gains, net  | (26,037 )                          | (16,170 )   |
| Net change in:   |                                    |             |
| Accrued interest receivable and other assets   | 7,983                              | (90,605 )   |
| Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities | 7,728                              | 26,094      |
| Net cash used in operating activities  | (756,124 )                         | (1,049,918) |
| Cash Flows From Investing Activities:  |                                    |             |
| Purchases of loans held-for-investment   | —                                  | (22,219 )   |
| Proceeds from sales of loans held-for-investment   | 219,639                            | —           |
| Principal payments on loans held-for-investment  | 574,037                            | 359,714     |
| Purchases of real estate securities  | (212,364 )                         | (66,601 )   |
| Proceeds from sales of real estate securities  | 482,716                            | 309,101     |
| Principal payments on real estate securities   | 60,978                             | 103,664     |
| Purchase of mortgage servicing rights  | (15,286 )                          | (23,315 )   |
| Proceeds from sales of mortgage servicing rights   | 35,717                             | 17,235      |
| Net change in restricted cash  | 3,523                              | (7,733 )    |
| Net cash provided by investing activities  | 1,148,960                          | 669,846     |
| Cash Flows From Financing Activities:  |                                    |             |
| Proceeds from borrowings on short-term debt  | 3,156,642                          | 6,213,505   |
| Repayments on short-term debt  | (3,894,240)                        | (6,160,226) |
| Repayments on asset-backed securities issued   | (208,801 )                         | (256,614 )  |
| Deferred securities issuance costs   | —                                  | (33 )       |
| Proceeds from issuance of long-term debt   | 771,287                            | 1,156,396   |
| Repayments on long-term debt   | (118,146 )                         | (502,268 )  |
| Net settlements of derivatives   | (119 )                             | (32 )       |
| Net proceeds from issuance of common stock   | 220                                | 7,198       |
| Net payments on repurchase of common stock   | (27,731 )                          | (32,042 )   |
| Taxes paid on equity award distributions   | (4,399 )                           | (8,092 )    |
| Dividends paid   | (66,406 )                          | (72,088 )   |
| Net cash (used in) provided by financing activities  | (391,693 )                         | 345,704     |
| Net increase (decrease) in cash and cash equivalents   | 1,143                              | (34,368 )   |
| Cash and cash equivalents at beginning of period   | 220,229                            | 269,730     |
| Cash and cash equivalents at end of period   | \$221,372                          | \$235,362   |
| Supplemental Cash Flow Information:  |                                    |             |

|   |          |          |
|---|----------|----------|
| Cash paid during the period for:  |          |          |
| Interest  | \$62,053 | \$57,998 |
| Taxes   | 826      | 55       |
| Supplemental Noncash Information:   |          |          |
| Real estate securities retained from loan securitizations                               | \$3,673  | \$39,698 |
| Retention of mortgage servicing rights from loan securitizations and sales              | 7,679    | 52,297   |
| Transfers from loans held-for-sale to loans held-for-investment                         | 877,744  | 964,013  |
| Transfers from loans held-for-investment to loans held-for-sale                         | 359,005  | 66,918   |
| Transfers from residential loans to real estate owned                                   | 8,479    | 5,740    |
| The accompanying notes are an integral part of these consolidated financial statements. |          |          |

REDWOOD TRUST, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
September 30, 2016  
(Unaudited)

Note 1. Organization

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

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

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2016 and December 31, 2015, and for the three and nine months ended September 30, 2016 and 2015. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with consolidated financial statements and notes thereto included in the company’s Annual Report on Form 10-K for the year ended December 31, 2015. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at September 30, 2016 and results of operations for all periods presented have been made. The results of operations for the three and nine months ended September 30, 2016 should not be construed as indicative of the results to be expected for the full year.

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

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

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

September 30, 2016

(Unaudited)

Note 2. Basis of Presentation - (continued)

Principles of Consolidation

In accordance with GAAP, we determine whether we must consolidate transferred financial assets and variable interest entities (“VIEs”) for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities where we maintain an ongoing involvement. From its creation in 2012 through the second quarter of 2016, when the third party financing was repaid, we consolidated the assets and liabilities of an entity formed in connection with a commercial securitization we engaged in (“Commercial Securitization”). We also consolidated the assets and liabilities of an entity formed in connection with a resecuritization transaction we engaged in (“Residential Resecuritization”) from its creation in 2011 through the fourth quarter of 2015, when the debt of the entity was repaid, the assets of the entity were distributed to us, and the entity was dissolved. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

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

See Note 4 for further discussion on principles of consolidation.

Use of Estimates

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

Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies

Included in Note 3 to the Consolidated Financial Statements of our 2015 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company's consolidated financial condition and results of operations for the three and nine months ended September 30, 2016.

Recent Accounting Pronouncements

Newly Adopted Accounting Standards Updates (“ASUs”)

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



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

In April 2015, the FASB issued ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs." This new guidance requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount. This new guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years, and is required to be applied on a retrospective basis. We adopted this guidance, as required, in the first quarter of 2016 and now present our deferred securities issuance costs as a reduction to the related liabilities on our consolidated balance sheets for all periods presented. At September 30, 2016 and December 31, 2015, we included zero and \$0.5 million, respectively, of deferred securities issuance costs as a reduction to our ABS issued and presented these amounts together as ABS issued, net on our consolidated balance sheets and we included \$8 million and \$10 million, respectively, of deferred securities issuance costs as a reduction to our long-term debt and presented these amounts together as Long-term debt, net on our consolidated balance sheets.

In February 2015, the FASB issued ASU 2015-02, "Consolidation (Topic 810) - Amendments to the Consolidation Analysis." This new guidance provides a new scope exception for certain money market funds, makes targeted amendments to the current consolidation guidance, and ends the deferral granted to investment companies from applying the VIE guidance. This new guidance is effective for annual periods beginning after December 15, 2015. We adopted this guidance, as required, in the first quarter of 2016, which did not have a material impact on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." This new guidance is to simplify the accounting for share-based payment transactions, including related income tax accounting, classification of awards, and classification on the statement of cash flows. In addition, this guidance permits the withholding of employee taxes related to the distribution of equity awards up to the maximum individual employee statutory tax rates. This new guidance is effective for fiscal years beginning after December 15, 2016 and early adoption is permitted. In the second quarter of 2016, we adopted this new guidance. Upon adoption, we elected to account for forfeitures on employee equity awards as they occur, rather than estimating expected forfeitures. The adoption of this guidance did not have a material impact on our consolidated financial statements.

Other Recent Accounting Pronouncements

In October 2016, the FASB issued ASU 2016-17, "Consolidation (Topic 810): Interests Held Through Related Parties that Are Under Common Control." This new guidance amends the consolidation guidance on how a reporting entity, that is the single decision maker of a VIE, evaluates whether it is the primary beneficiary of a VIE. This new guidance is effective for fiscal years beginning after December 15, 2016. Early adoption is permitted. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have on our consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory." This new guidance allows an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. It also eliminates the exceptions for an intra-entity transfer of assets other than inventory. This new guidance is effective for fiscal years beginning after December 15, 2017. Early adoption is permitted. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have on our consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." This new guidance provides guidance on how to present and classify certain cash receipts and cash payments in the statement of cash flows. This new guidance is effective for fiscal years beginning after December 15, 2017. Early adoption is permitted. We plan to adopt this new guidance by the required date and we



are currently evaluating the impact that this update will have on our consolidated financial statements. In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses." This new guidance provides a new impairment model that is based on expected losses rather than incurred losses to determine the allowance for credit losses. This new guidance is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted for fiscal year beginning December 15, 2018. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have on our consolidated financial statements.

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

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

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

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers." The update modifies the guidance companies use to recognize revenue from contracts with customers for transfers of goods or services and transfers of nonfinancial assets, unless those contracts are within the scope of other standards. The guidance also requires new qualitative and quantitative disclosures, including information about contract balances and performance obligations. In July 2015, the FASB approved a one year deferral of the effective date. Accordingly, the update is effective for us in the first quarter of 2018 with retrospective application to prior periods presented or as a cumulative effect adjustment in the period of adoption. Early adoption is permitted in the first quarter of 2017. In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)." This new guidance provides additional implementation guidance on how an entity should identify the unit of accounting for the principal versus agent evaluations. In May 2016, the FASB issued ASU 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients." This new ASU provides more specific guidance on certain aspects of Topic 606. Based on our initial evaluation of this new accounting standard, we do not expect that its adoption will have a material impact on our consolidated financial statements, as financial instruments are explicitly scoped out of the standard and nearly all of our income is generated from financial instruments. We will continue evaluating this new standard and caution that any changes in our business or additional amendments to this standard could change our initial assessment.

Balance Sheet Netting

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

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

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at September 30, 2016 and December 31, 2015.

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

| September 30, 2016<br>(In Thousands) | Gross<br>Amounts of<br>Recognized<br>Assets<br>(Liabilities) | Gross<br>Amounts<br>Offset in<br>Consolidated<br>Balance<br>Sheet | Net Amounts<br>of Assets<br>(Liabilities)<br>Presented in<br>Consolidated<br>Balance<br>Sheet | Gross Amounts Not<br>Offset in Consolidated<br>Balance Sheet <sup>(1)</sup><br>Financial<br>Instruments | Cash<br>Collateral<br>(Received)<br>Pledged | Net<br>Amount |
|--------------------------------------|--|---|---|---|---|---------------|
| Assets <sup>(2)</sup>                |  |   |   |   |   |               |
| Interest rate agreements             | \$29,073   | \$  | —\$29,073   | \$(25,048 )   | \$(4,025 )                                  | \$ —          |
| TBAs                                 | 1,514  | —   | 1,514   | (1,467 )  | —   | 47            |
| Futures                              | 257  | —   | 257   | (54 )   | —   | 203           |
| Total Assets                         | \$30,844   | \$  | —\$30,844   | \$(26,569 )   | \$(4,025 )                                  | \$ 250        |
| Liabilities <sup>(2)</sup>           |  |   |   |   |   |               |
| Interest rate agreements             | \$(95,171 )  | \$  | —\$(95,171 )  | \$25,048  | \$ 70,123                                   | \$ —          |
| TBAs                                 | (4,335 )   | —   | (4,335 )  | 1,467   | 2,772                                       | (96 )         |
| Futures                              | (54 )  | —   | (54 )   | 54  | —   | —             |
| Loan warehouse debt                  | (837,846 )   | —   | (837,846 )  | 837,846   | —   | —             |
| Security repurchase agreements       | (279,559 )   | —   | (279,559 )  | 279,559   | —   | —             |
| Total Liabilities                    | \$(1,216,965 )   | \$  | —\$(1,216,965 )   | \$1,143,974   | \$ 72,895                                   | \$ (96 )      |

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 3. Summary of Significant Accounting Policies - (continued)

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

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

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



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Note 4. Principles of Consolidation

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

Analysis of Consolidated VIEs

At September 30, 2016, we consolidated certain Sequoia securitization entities issued prior to 2012 that we determined were VIEs and for which we determined we were the primary beneficiary. As discussed in Note 2, we previously consolidated our Commercial Securitization through the second quarter of 2016 and our Residential Resecuritization through the fourth quarter of 2015. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

Table 4.1 – Assets and Liabilities of Consolidated VIEs

| September 30, 2016<br>(Dollars in Thousands) | Sequoia<br>Entities |
|--|---------------------|
| Residential loans, held-for-investment       | \$839,976           |
| Restricted cash                              | 148                 |
| Accrued interest receivable                  | 1,030               |
| Other assets                                 | 6,245               |
| Total Assets                                 | \$847,399           |
| Accrued interest payable                     | \$523               |
| Asset-backed securities issued               | 819,868             |
| Total Liabilities                            | \$820,391           |
| Number of VIEs                               | 20                  |

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Note 4. Principles of Consolidation - (continued)

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

|                |    |   |    |
|----------------|----|---|----|
| Number of VIEs | 21 | 1 | 22 |
|----------------|----|---|----|

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 28 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes, in accordance with ASC 860. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSR's on our consolidated balance sheets, and classified those MSR's as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets. Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSR's (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.

The following table presents information related to securitization transactions that occurred during the three and nine months ended September 30, 2016 and 2015.

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

| (In Thousands)                             | Three Months<br>Ended<br>September 30, |      | Nine Months Ended<br>September 30, |             |
|--|--|------|------------------------------------|-------------|
|  | 2016                                   | 2015 | 2016                               | 2015        |
| Principal balance of loans transferred     | \$348,537                              | \$ — | -\$693,427                         | \$1,038,451 |
| Trading securities retained, at fair value | —                                      | —    | —                                  | 33,389      |
| AFS securities retained, at fair value     | 1,839                                  | —    | 3,673                              | 6,309       |
| MSR's recognized                           | 1,971                                  | —    | 4,102                              | 7,874       |

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Note 4. Principles of Consolidation - (continued)

The following table summarizes the cash flows during the three and nine months ended September 30, 2016 and 2015 between us and the unconsolidated VIEs sponsored by us.

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

| (In Thousands)                             | Three Months Ended September 30, |       | Nine Months Ended September 30, |             |
|--|----------------------------------|-------|---------------------------------|-------------|
|  | 2016                             | 2015  | 2016                            | 2015        |
| Proceeds from new transfers                | \$356,497                        | \$ —  | \$708,539                       | \$1,018,312 |
| MSR fees received                          | 3,473                            | 3,817 | 10,397                          | 11,287      |
| Funding of compensating interest           | (98 )                            | (86 ) | (254 )                          | (283 )      |
| Cash flows received on retained securities | 6,384                            | 8,190 | 24,314                          | 31,541      |

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

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

| At Date of Securitization | Three Months Ended September 30, 2016 |                        |  | Three Months Ended September 30, 2015 |                   |                        |
|---------------------------|---------------------------------------|------------------------|--|---------------------------------------|-------------------|------------------------|
|                           | MSRs                                  | Subordinate Securities |  | MSRs                                  | Senior Securities | Subordinate Securities |
| Prepayment rate           | 24 %                                  | 15 %                   |  | N/A                                   | N/A               | N/A                    |
| Discount rates            | 11 %                                  | 7 %                    |  | N/A                                   | N/A               | N/A                    |
| Credit loss assumptions   | N/A                                   | 0.25 %                 |  | N/A                                   | N/A               | N/A                    |

  

| At Date of Securitization | Nine Months Ended September 30, 2016 |                        |  | Nine Months Ended September 30, 2015 |                   |                        |
|---------------------------|--------------------------------------|------------------------|--|--------------------------------------|-------------------|------------------------|
|                           | MSRs                                 | Subordinate Securities |  | MSRs                                 | Senior Securities | Subordinate Securities |
| Prepayment rate           | 22 %                                 | 15 %                   |  | 14 %                                 | 8 %               | 8 %                    |
| Discount rates            | 11 %                                 | 7 %                    |  | 11 %                                 | 3 %               | 6 %                    |
| Credit loss assumptions   | N/A                                  | 0.25 %                 |  | N/A                                  | 0.25 %            | 0.25 %                 |



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Note 4. Principles of Consolidation - (continued)

The following table presents additional information at September 30, 2016 and December 31, 2015, related to unconsolidated VIEs sponsored by Redwood and accounted for as sales since 2012.

Table 4.5 – Unconsolidated VIEs Sponsored by Redwood

| (In Thousands)  | September 30,<br>2016 | December 31,<br>2015 |
|---|-----------------------|----------------------|
| On-balance sheet assets, at fair value:                                 |                       |                      |
| Interest-only, senior and subordinate securities, classified as trading | \$ 31,271             | \$ 258,697           |
| Subordinate securities, classified as AFS                               | 237,248               | 272,715              |
| Mortgage servicing rights   | 35,609                | 56,984               |
| Maximum loss exposure <sup>(1)</sup>                                    | \$ 304,128            | \$ 588,396           |
| Assets transferred:   |                       |                      |
| Principal balance of loans outstanding                                  | \$ 6,990,350          | \$ 7,318,167         |
| Principal balance of delinquent loans 30+ days delinquent               | 19,775                | 18,300               |

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

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at September 30, 2016 and December 31, 2015.

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

| September 30, 2016<br>(Dollars in Thousands)            | MSRs     | Senior<br>Securities<br>(1) | Subordinate<br>Securities |
|---|----------|-----------------------------|---------------------------|
| Fair value at September 30, 2016                        | \$35,609 | \$19,098                    | \$249,421                 |
| Expected life (in years) <sup>(2)</sup>                 | 5        | 5                           | 12                        |
| Prepayment speed assumption (annual CPR) <sup>(2)</sup> | 25       | % 14                        | % 14                      |
| Decrease in fair value from:                            |          |                             |                           |
| 10% adverse change                                      | \$2,414  | \$893                       | \$955                     |
| 25% adverse change                                      | 5,687    | 2,119                       | 2,364                     |
| Discount rate assumption <sup>(2)</sup>                 | 11       | % 15                        | % 5                       |
| Decrease in fair value from:                            |          |                             |                           |
| 100 basis point increase                                | \$861    | \$551                       | \$19,395                  |
| 200 basis point increase                                | 1,674    | 1,072                       | 36,292                    |
| Credit loss assumption <sup>(2)</sup>                   | N/A      | 0.25                        | % 0.25                    |
| Decrease in fair value from:                            |          |                             |                           |
| 10% higher losses                                       | N/A      | \$11                        | \$1,220                   |
| 25% higher losses                                       | N/A      | 27                          | 3,048                     |



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Note 4. Principles of Consolidation - (continued)

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

(1) Senior securities included \$19 million and \$31 million of interest only securities at September 30, 2016 and December 31, 2015, respectively.

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

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at September 30, 2016, grouped by security type.

Table 4.7 – Third-Party Sponsored VIE Summary

| (Dollars in Thousands)                          | September 30,<br>2016 |
|---|-----------------------|
| Mortgage Backed Securities                      |                       |
| Senior  | \$ 76,685             |
| Re-REMIC  | 161,234               |
| Subordinate                                     | 430,471               |
| Total Investments in Third-Party Sponsored VIEs | \$ 668,390            |

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

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

material impact to our financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 5. Fair Value of Financial Instruments

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at September 30, 2016 and December 31, 2015.

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

| (In Thousands)                         | September 30, 2016 |             | December 31, 2015 |             |
|--|--------------------|-------------|-------------------|-------------|
|  | Carrying Value     | Fair Value  | Carrying Value    | Fair Value  |
| <b>Assets</b>                          |                    |             |                   |             |
| Residential loans, held-for-sale       |                    |             |                   |             |
| At fair value                          | \$1,187,240        | \$1,187,240 | \$1,114,305       | \$1,114,305 |
| At lower of cost or fair value         | 1,274              | 1,459       | 1,433             | 1,635       |
| Residential loans, held-for-investment |                    |             |                   |             |
| At fair value                          | 3,122,650          | 3,122,650   | 2,813,065         | 2,813,065   |
| Commercial loans, held-for-sale        |                    |             |                   |             |
| At fair value                          | —                  | —           | 39,141            | 39,141      |
| At lower of cost or fair value         | 30,400             | 32,239      | —                 | —           |
| Commercial loans, held-for-investment  |                    |             |                   |             |
| At fair value                          | —                  | —           | 67,657            | 67,657      |
| At amortized cost                      | —                  | —           | 295,849           | 300,824     |
| Trading securities                     |                    |             |                   |             |
| Available-for-sale securities          | 341,269            | 341,269     | 404,011           | 404,011     |
| MSRs                                   | 595,641            | 595,641     | 829,245           | 829,245     |
| Cash and cash equivalents              | 106,009            | 106,009     | 191,976           | 191,976     |
| Restricted cash                        | 221,372            | 221,372     | 220,229           | 220,229     |
| Accrued interest receivable            | 2,044              | 2,044       | 5,567             | 5,567       |
| Derivative assets                      | 20,054             | 20,054      | 23,290            | 23,290      |
| REO <sup>(1)</sup>                     | 36,880             | 36,880      | 16,393            | 16,393      |
| Margin receivable <sup>(1)</sup>       | 6,245              | 6,342       | 4,896             | 5,282       |
| FHLBC stock <sup>(1)</sup>             | 96,650             | 96,650      | 83,191            | 83,191      |
| Guarantee asset <sup>(1)</sup>         | 43,393             | 43,393      | 34,437            | 34,437      |
| Pledged collateral <sup>(1)</sup>      | 3,627              | 3,627       | 5,697             | 5,697       |
| <b>Liabilities</b>                     |                    |             |                   |             |
| Short-term debt                        |                    |             |                   |             |
| Accrued interest payable               | \$1,117,405        | \$1,117,405 | \$1,855,003       | \$1,855,003 |
| Margin payable                         | 15,518             | 15,518      | 8,936             | 8,936       |
| Guarantee obligation                   | 13,313             | 13,313      | 6,415             | 6,415       |
| Derivative liabilities                 | 23,011             | 21,968      | 22,704            | 22,702      |
| ABS issued, net <sup>(2)</sup>         |                    |             |                   |             |
| Fair value                             | 100,117            | 100,117     | 62,794            | 62,794      |
| Amortized cost                         | 819,868            | 819,868     | 996,820           | 996,820     |
| FHLBC long-term borrowings             | —                  | —           | 52,595            | 53,137      |
| Commercial secured borrowings          | 1,999,999          | 1,999,999   | 1,343,023         | 1,343,023   |
|  | —                  | —           | 63,152            | 63,152      |

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|   |         |         |         |         |
|---|---------|---------|---------|---------|
| Convertible notes, net <sup>(2)</sup>                                 | 481,396 | 496,719 | 483,119 | 461,053 |
| Trust preferred securities and subordinated notes, net <sup>(2)</sup> | 138,478 | 83,700  | 138,443 | 83,700  |

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

On January 1, 2016, we adopted ASU 2015-03 and began to present ABS issued, convertible notes, and trust preferred securities and subordinated notes, each net of deferred debt issuance costs. See Note 3 for further discussion.

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 5. Fair Value of Financial Instruments - (continued)

During the three and nine months ended September 30, 2016, we elected the fair value option for \$64 million and \$187 million of subordinate securities, \$1.22 billion and \$3.73 billion of residential loans (principal balance), and \$3 million and \$23 million of MSR's, respectively. We anticipate electing the fair value option for all future purchases of residential loans that we intend to sell to third parties or transfer to securitizations as well as for MSR's purchased or retained from sales of residential loans.

The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at September 30, 2016 and December 31, 2015, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

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

| September 30, 2016<br><br>(In Thousands) | Carrying<br>Value | Fair Value Measurements<br>Using |           |             |
|--|-------------------|----------------------------------|-----------|-------------|
|  |                   | Level<br>1                       | Level 2   | Level 3     |
| <b>Assets</b>                            |                   |                                  |           |             |
| Residential loans                        | \$4,309,890       | \$—                              | \$—       | \$4,309,890 |
| Trading securities                       | 341,269           | —                                | —         | 341,269     |
| Available-for-sale securities            | 595,641           | —                                | —         | 595,641     |
| Derivative assets                        | 36,880            | 1,771                            | 29,073    | 6,036       |
| MSR's                                    | 106,009           | —                                | —         | 106,009     |
| Pledged collateral                       | 43,802            | 43,802                           | —         | —           |
| FHLBC stock                              | 43,393            | —                                | 43,393    | —           |
| Guarantee asset                          | 3,627             | —                                | —         | 3,627       |
| <b>Liabilities</b>                       |                   |                                  |           |             |
| Derivative liabilities                   | \$100,117         | \$4,389                          | \$95,171  | \$557       |
| ABS issued                               | 819,868           | —                                | —         | 819,868     |
| <br>                                     |                   |                                  |           |             |
| December 31, 2015<br><br>(In Thousands)  | Carrying<br>Value | Fair Value Measurements<br>Using |           |             |
|  |                   | Level<br>1                       | Level 2   | Level 3     |
| <b>Assets</b>                            |                   |                                  |           |             |
| Residential loans                        | \$3,927,370       | \$—                              | \$129,819 | \$3,797,551 |
| Commercial loans                         | 106,798           | —                                | —         | 106,798     |
| Trading securities                       | 404,011           | —                                | —         | 404,011     |
| Available-for-sale securities            | 829,245           | —                                | —         | 829,245     |
| Derivative assets                        | 16,393            | 2,734                            | 8,988     | 4,671       |
| MSR's                                    | 191,976           | —                                | —         | 191,976     |
| Pledged collateral                       | 53,600            | 53,600                           | —         | —           |
| FHLBC stock                              | 34,437            | —                                | 34,437    | —           |
| Guarantee asset                          | 5,697             | —                                | —         | 5,697       |



Liabilities

|                               |          |         |          |         |
|-------------------------------|----------|---------|----------|---------|
| Derivative liabilities        | \$62,794 | \$2,963 | \$58,368 | \$1,463 |
| Commercial secured borrowings | 63,152   | —       | —        | 63,152  |
| ABS issued                    | 996,820  | —       | —        | 996,820 |

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

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the nine months ended September 30, 2016.

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

| (In Thousands)                        | Assets            |                  |                    |                |           |                 | Liabilities |                               |            |
|---------------------------------------|-------------------|------------------|--------------------|----------------|-----------|-----------------|-------------|-------------------------------|------------|
|                                       | Residential Loans | Commercial Loans | Trading Securities | AFS Securities | MSRs      | Guarantee Asset | Derivatives | Commercial Secured Borrowings | ABS Issued |
| Beginning balance - December 31, 2015 | \$3,797,551       | \$106,798        | \$404,011          | \$829,245      | \$191,976 | \$5,697         | \$3,208     | \$63,152                      | \$996,820  |
| Acquisitions                          | 3,615,003         | 37,625           | 187,149            | 28,888         | 22,941    | —               | —           | —                             | —          |
| Sales                                 | (2,544,595)       | (81,523)         | (241,208)          | (241,232)      | (38,419)  | —               | —           | —                             | —          |
| Principal paydowns                    | (569,591)         | (476)            | (13,591)           | (47,387)       | —         | —               | —           | (306)                         | (155,662)  |
| Gains (losses) in net income, net     | 13,126            | 2,791            | 4,908              | 41,537         | (70,489)  | (2,070)         | 41,110      | 2,369                         | (14,419)   |
| Unrealized losses in OCI, net         | —                 | —                | —                  | (15,410)       | —         | —               | —           | —                             | —          |
| Other settlements, net <sup>(2)</sup> | (1,604)           | (65,215)         | —                  | —              | —         | —               | (38,839)    | (65,215)                      | (6,871)    |
| Ending Balance - September 30, 2016   | \$4,309,890       | \$—              | \$341,269          | \$595,641      | \$106,009 | \$3,627         | \$5,479     | \$—                           | \$819,868  |

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

(2) Other settlements, net for derivatives represents the transfer of the fair value of loan purchase commitments at the time loans are acquired to the basis of residential loans. For commercial secured borrowings, the reduction represents the derecognition of our commercial secured borrowings and related commercial A-note investments upon sale of the associated B-notes.

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

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at September 30, 2016 and 2015. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and nine months ended September 30, 2016 and 2015 are not included in this presentation.

Table 5.4 – Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at September 30, 2016 and 2015 Included in Net Income

| (In Thousands)                                     | Included in Net Income   |           |                          |           |
|--|--------------------------|-----------|--------------------------|-----------|
|  | Three Months             |           | Nine Months              |           |
|  | Ended September 30, 2016 | 2015      | Ended September 30, 2016 | 2015      |
| <b>Assets</b>                                      |                          |           |                          |           |
| Residential loans at Redwood                       | \$3,818                  | \$16,451  | \$32,202                 | \$12,115  |
| Residential loans at consolidated Sequoia entities | 9,200                    | (419 )    | (18,864 )                | 4,912     |
| Commercial loans                                   | —                        | 3,175     | —                        | 1,971     |
| Trading securities                                 | 8,646                    | (8,298 )  | 978                      | (13,274 ) |
| Available-for-sale securities                      | —                        | (226 )    | (305 )                   | (226 )    |
| MSRs   | 6,549                    | (25,523 ) | (36,738 )                | (15,989 ) |
| Loan purchase commitments                          | 5,381                    | —         | 5,896                    | —         |
| Other assets - Guarantee asset                     | 307                      | (1,098 )  | (2,070 )                 | (1,799 )  |
| <b>Liabilities</b>                                 |                          |           |                          |           |
| Loan purchase commitments                          | \$—                      | \$9,736   | \$—                      | \$9,806   |
| Commercial secured borrowing                       | —                        | (454 )    | —                        | 750       |
| ABS issued   | 10,522                   | 300       | (14,419 )                | (6,198 )  |

The following table presents information on assets recorded at fair value on a non-recurring basis at September 30, 2016. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our consolidated balance sheet at September 30, 2016.

Table 5.5 – Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at September 30, 2016

| September 30, 2016                                | Carrying Value | Fair Value Measurements Using |      |         | Gain (Loss) for                       |                                      |
|---|----------------|-------------------------------|------|---------|---------------------------------------|--------------------------------------|
|   |                | Level 1                       |      | Level 3 | Three Months Ended September 30, 2016 | Nine Months Ended September 30, 2016 |
|   |                | 1                             | 2    | Level 3 | 2016                                  | 2016                                 |
| <b>Assets</b>                                     |                |                               |      |         |                                       |                                      |
| Residential loans, at lower of cost or fair value | \$ 954         | \$ —                          | \$ — | \$ 954  | \$ 3                                  | \$ 36                                |
| Commercial loans, at lower of cost or fair value  | 2,700          | —                             | —    | 2,700   | (300)                                 | (300 )                               |
| REO   | 1,989          | —                             | —    | 1,989   | (139)                                 | (351 )                               |

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

The following table presents the net market valuation gains and losses recorded in each line item of our consolidated statements of income for the three and nine months ended September 30, 2016 and 2015.

Table 5.6 – Market Valuation Gains and Losses, Net

| (In Thousands)  | Three Months<br>Ended September<br>30, |            | Nine Months Ended<br>September 30, |            |
|---|--|------------|------------------------------------|------------|
|   | 2016                                   | 2015       | 2016                               | 2015       |
| Mortgage Banking Activities, Net                        |  |            |                                    |            |
| Residential loans held-for-sale, at fair value          | \$650                                  | \$11,010   | \$11,948                           | \$9,892    |
| Residential loan purchase and forward sale commitments  | 12,021                                 | 25,173     | 35,508                             | 44,482     |
| Commercial loans, at fair value <sup>(1)</sup>          | —                                      | 3,974      | 433                                | 10,819     |
| Sequoia securities                                      | —                                      | —          | 1,455                              | (14,359 )  |
| Risk management derivatives, net                        | (3,287 )                               | (40,110 )  | (25,281 )                          | (43,674 )  |
| Total mortgage banking activities, net <sup>(2)</sup>   | \$9,384                                | \$47       | \$24,063                           | \$7,160    |
| Investment Fair Value Changes, Net                      |  |            |                                    |            |
| Residential loans held-for-investment at Redwood        | \$(655 )                               | \$9,077    | \$22,161                           | \$5,170    |
| Trading securities                                      | 8,898                                  | (8,784 )   | 3,728                              | (1,587 )   |
| Valuation adjustments on commercial loans held-for-sale | (307 )                                 | —          | (307 )                             | —          |
| Net investments in consolidated Sequoia entities        | (255 )                                 | (500 )     | (2,086 )                           | (2,277 )   |
| Risk sharing investments                                | 15                                     | (1,098 )   | (689 )                             | (1,799 )   |
| Risk management derivatives, net                        | 4,222                                  | (12,638 )  | (41,188 )                          | (16,386 )  |
| Impairments on AFS securities                           | —                                      | (226 )     | (305 )                             | (226 )     |
| Total investment fair value changes, net                | \$11,918                               | \$(14,169) | \$(18,686)                         | \$(17,105) |
| MSR Income (Loss), Net                                  |  |            |                                    |            |
| MSRs  | \$1,380                                | \$(28,496) | \$(70,489)                         | \$(32,337) |
| Risk management derivatives, net                        | (6,336 )                               | 23,551     | 55,874                             | 1,736      |
| Total MSR loss, net <sup>(3)</sup>                      | \$(4,956 )                             | \$(4,945 ) | \$(14,615)                         | \$(30,601) |
| Total Market Valuation Gains (Losses), Net              | \$16,346                               | \$(19,067) | \$(9,238 )                         | \$(40,546) |

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

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

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



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

At September 30, 2016, our valuation policy and processes had not changed from those described in our Annual Report on Form 10-K for the year ended December 31, 2015. The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

Table 5.7 – Fair Value Methodology for Level 3 Financial Instruments

| September 30, 2016<br>(Dollars in Thousands, except Input<br>Values) | Fair<br>Value | Unobservable Input               | Input Values<br>Range |         |     | Weighted<br>Average |     |
|--|---------------|----------------------------------|-----------------------|---------|-----|---------------------|-----|
| Assets   |               |                                  |                       |         |     |                     |     |
| Residential loans, at fair value:                                    |               |                                  |                       |         |     |                     |     |
| Jumbo fixed rate loans   | \$2,404,070   | Whole loan spread to TBA price   | \$3.04                | -\$4.35 |     | \$4.31              |     |
|  |               | Whole loan spread to swap rate   | 275                   | -325    | bps | 324                 | bps |
| Jumbo hybrid loans   | 160,047       | Prepayment rate (annual CPR)     | 15                    | -15     | %   | 15                  | %   |
|  |               | Whole loan spread to swap rate   | 130                   | -275    | bps | 150                 | bps |
| Jumbo loans committed to sell  | 905,797       | Whole loan committed sales price | \$101.42-\$103.08     |         |     | \$102.22            |     |
|  |               | IO multiple                      | 2.8                   | -2.8    | x   | 2.8                 | x   |
|  |               | Prepayment rate (annual CPR)     | 15                    | -15     | %   | 15                  | %   |
|  |               | Senior spread to TBA price       | \$2.13                | -\$2.13 |     | \$2.13              |     |
|  |               | Subordinate spread to swap rate  | 200                   | -857    | bps | 313                 | bps |
|  |               | Credit support                   | 5                     | -5      | %   | 5                   | %   |
| Loans held by consolidated Sequoia entities <sup>(1)</sup>           | 839,976       | Liability price                  | N/A                   |         |     | N/A                 |     |
| Residential loans, at lower of cost or fair value                    | 954           | Loss severity                    | 15                    | -30     | %   | 17                  | %   |
| Trading and AFS securities   | 936,910       | Discount rate                    | 5                     | -12     | %   | 7                   | %   |
|  |               | Prepayment rate (annual CPR)     | 1                     | -41     | %   | 18                  | %   |
|  |               | Default rate                     | 0                     | -35     | %   | 2                   | %   |
|  |               | Loss severity                    | 20                    | -65     | %   | 21                  | %   |
|  |               | Credit support                   | 0                     | -48     | %   | 3                   | %   |
| MSRs   | 106,009       | Discount rate                    | 11                    | -11     | %   | 11                  | %   |
|  |               | Prepayment rate (annual CPR)     | 9                     | -25     | %   | 18                  | %   |
|  |               | Per loan annual cost to service  | \$72                  | -\$82   |     | \$78                |     |
| Guarantee asset  | 3,627         | Discount rate                    | 11                    | -11     | %   | 11                  | %   |
|  |               | Prepayment rate (annual CPR)     | 18                    | -18     | %   | 18                  | %   |

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|   |         |   |        |         |     |        |     |
|---|---------|---|--------|---------|-----|--------|-----|
| REO   | 5,396   | Loss severity                               | 2      | -100    | %   | 21     | %   |
| Loan purchase commitments, net <sup>(2)</sup> | 5,479   | MSR multiple                                | 0.9    | -4.7    | x   | 2.7    | x   |
|   |         | Fallout rate                                | 2      | -85     | %   | 28     | %   |
|   |         | Whole loan spread to TBA price              | \$3.04 | -\$4.20 |     | \$4.16 |     |
|   |         | Whole loan spread to swap rate - fixed rate | 275    | -325    | bps | 324    | bps |
|   |         | Prepayment rate (annual CPR)                | 15     | -15     | %   | 15     | %   |
|   |         | Whole loan spread to swap rate - hybrid     | 130    | -275    | bps | 156    | bps |
| Liabilities                                   |         |   |        |         |     |        |     |
| ABS issued                                    | 819,868 | Discount rate                               | 5      | -9      | %   | 5      | %   |
|   |         | Prepayment rate (annual CPR)                | 2      | -20     | %   | 15     | %   |
|   |         | Default rate                                | 1      | -12     | %   | 7      | %   |
|   |         | Loss severity                               | 20     | -32     | %   | 27     | %   |
|   |         | Credit support                              | 0      | -22     | %   | 13     | %   |

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

Footnotes to Table 5.7

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

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

Determination of Fair Value

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

Residential loans

Estimated fair values for residential loans are determined using models that incorporate various observable inputs, including pricing information from recent securitizations and whole loan sales. Certain significant inputs in these models are considered unobservable and are therefore Level 3 in nature. Pricing inputs obtained from market securitization activity include indicative spreads to indexed TBA prices for senior residential mortgage-backed securities ("RMBS") and indexed swap rates for subordinate RMBS (Level 3). Pricing inputs obtained from market whole loan transaction activity include indicative spreads to indexed to be announced ("TBA") prices and indexed swap rates for fixed-rate loans and indexed swap rates for hybrid loans (Level 3). Other observable inputs include benchmark interest rates, and prepayment rates. At September 30, 2016, our jumbo fixed-rate loans that were not committed to sell were priced exclusively using whole loan sale inputs. These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed, or credit support assumptions.

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

Commercial loans

Estimated fair values for mezzanine commercial loans are determined by both market comparable pricing and discounted cash flow analysis valuation techniques (Level 3). Our discounted cash flow models utilize certain significant unobservable inputs including the underwritten net operating income and debt coverage ratio assumptions and actual performance relative to those underwritten metrics as well as estimated market discount rates. In certain cases, commercial loans are valued based on third-party offers for the loans (Level 2). An increase in market discount rates would generally reduce the estimated fair value of the commercial loans.

Estimated fair values for senior commercial loans held-for-sale are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses include pricing points for current third-party commercial mortgage-backed securities ("CMBS") sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). The estimated fair value of our senior commercial loans would generally decrease based upon an increase in credit spreads or required credit support.

Real estate securities



Real estate securities include residential, commercial, and other asset-backed securities that are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators that are factored into the analyses include bid/ask spreads, the amount and timing of credit losses, interest rates, and collateral prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. The estimated fair value of our securities would generally decrease based upon an increase in default rates, serious delinquencies, or a decrease in prepayment rates or credit support.

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

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at September 30, 2016, we received dealer price indications on 72% of our securities, representing 82% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were within 1% of the aggregate average dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Derivative assets and liabilities

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

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

MSRs

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

As part of our MSR valuation process, we received a valuation estimate from a third-party valuations firm. In the aggregate, our internal valuation of the MSRs were approximately 5% lower than the third-party valuation.

FHLBC Stock

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

Guarantee Asset

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

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 5. Fair Value of Financial Instruments - (continued)

Pledged Collateral

Pledged collateral consists of cash and U.S. Treasury securities held by a custodian in association with certain agreements we have entered into. Treasury securities are carried at their fair value, which is determined using quoted prices in active markets (Level 1).

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

REO

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

Margin receivable

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

Guarantee Obligations

In association with our risk sharing transactions with the Agencies, we have made certain guarantees. These obligations are initially recorded at fair value and subsequently carried at amortized cost. Fair values of guarantee obligations are determined using internal models that incorporate certain significant inputs that are considered unobservable and are therefore Level 3 in nature. Pricing inputs include prepayment assumptions, loss assumptions, and discount rates. An increase in discount rates or loss rates, or a decrease in prepayment rates, would reduce the estimated fair value of the guarantee obligations.

Short-term debt

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

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 5. Fair Value of Financial Instruments - (continued)

ABS issued

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

FHLBC Borrowings

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

Commercial secured borrowings

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

Convertible notes

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

Trust preferred securities and subordinated notes

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

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 6. Residential Loans

We acquire residential loans from third-party originators. The following table summarizes the classifications and carrying values of the residential loans owned at Redwood and at consolidated Sequoia entities at September 30, 2016 and December 31, 2015.

Table 6.1 – Classifications and Carrying Values of the Residential Loans

September 30, 2016

| (In Thousands)                         | Redwood     | Sequoia   | Total       |
|--|-------------|-----------|-------------|
| Held-for-sale                          |             |           |             |
| At fair value - jumbo                  | \$1,187,240 | \$—       | \$1,187,240 |
| At lower of cost or fair value - jumbo | 1,274       | —         | 1,274       |
| Total held-for-sale                    | 1,188,514   | —         | 1,188,514   |
| Held-for-investment                    |             |           |             |
| At fair value - jumbo                  | 2,282,674   | 839,976   | 3,122,650   |
| Total Residential Loans                | \$3,471,188 | \$839,976 | \$4,311,164 |

December 31, 2015

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

At September 30, 2016, we owned mortgage servicing rights associated with \$2.58 billion (principal balance) of consolidated residential loans purchased from third-party originators. The value of these MSR is included in the carrying value of the associated loans on our consolidated balance sheet. We contract with licensed sub-servicers that perform servicing functions for these loans.

Residential Loans Held-for-Sale

At Fair Value

At September 30, 2016, we owned 1,528 loans held-for-sale at fair value with an aggregate unpaid principal balance of \$1.16 billion and a fair value of \$1.19 billion, compared to 1,763 loans with an aggregate unpaid principal balance of \$1.09 billion and a fair value of \$1.11 billion at December 31, 2015. At September 30, 2016, none of these loans were greater than 90 days delinquent or in foreclosure. At December 31, 2015, one of these loans with a fair value of \$1 million was greater than 90 days delinquent and one of these loans with a fair value of \$1 million was in foreclosure.

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 6. Residential Loans - (continued)

During the three and nine months ended September 30, 2016, we purchased \$1.22 billion and \$3.73 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold \$755 million and \$2.80 billion (principal balance) of loans, respectively, for which we recorded net market valuation gains of \$1 million and \$12 million, respectively, through Mortgage banking activities, net, a component of our consolidated statements of income. At September 30, 2016, loans held-for-sale with a market value of \$941 million were pledged as collateral under short-term borrowing agreements.

During the three and nine months ended September 30, 2015, we purchased \$2.91 billion and \$8.09 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold \$2.07 billion and \$7.00 billion (principal balance) of loans, respectively, for which we recorded net market valuation gains of \$11 million and \$10 million, respectively, through Mortgage banking activities, net, a component of our consolidated statements of income.

At Lower of Cost or Fair Value

At September 30, 2016 and December 31, 2015, we held eight and nine, respectively, residential loans at the lower of cost or fair value with \$2 million in outstanding principal balance for both periods and a carrying value of \$1 million for both periods. At September 30, 2016, one of these loans with an unpaid principal balance of \$0.4 million was greater than 90 days delinquent and one of these loans with an unpaid principal balance of \$0.1 million was in foreclosure. At December 31, 2015, one of these loans with an unpaid principal balance of \$0.4 million was greater than 90 days delinquent and one of these loans with an unpaid principal balance of \$0.1 million was in foreclosure.

Residential Loans Held-for-Investment at Fair Value

At Redwood

At September 30, 2016, we owned 3,056 held-for-investment loans at Redwood with an aggregate unpaid principal balance of \$2.21 billion and a fair value of \$2.28 billion, compared to 2,398 loans with an aggregate unpaid principal balance of \$1.76 billion and a fair value of \$1.79 billion at December 31, 2015. At both September 30, 2016 and December 31, 2015, none of these loans were greater than 90 days delinquent or in foreclosure.

During the three and nine months ended September 30, 2016, we transferred loans with a fair value of \$152 million and \$878 million, respectively, from held-for-sale to held-for-investment. During the three and nine months ended September 30, 2016, we transferred loans with a fair value of zero and \$56 million, respectively, from held-for-investment to held-for-sale. During the three and nine months ended September 30, 2016, we recorded a net market valuation loss of \$1 million and a net market valuation gain of \$22 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net, a component of our consolidated statements of income. At September 30, 2016, loans with a fair value of \$2.27 billion were pledged as collateral under a borrowing agreement with the FHLBC.

During the three and nine months ended September 30, 2015, we transferred loans with a fair value of \$300 million and \$962 million, respectively, from held-for-sale to held-for-investment. During the three months ended September 30, 2015, we transferred loans with a fair value of \$67 million from held-for-investment to held-for-sale. During the three and nine months ended September 30, 2015, we recorded net market valuation gains of \$9 million and \$5 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net, a component of our consolidated statements of income.

At September 30, 2016, the outstanding loans held-for-investment at Redwood were prime-quality, first lien loans, of which 93% were originated between 2013 and 2016, and 7% were originated in 2012 and prior years. The weighted average FICO score of borrowers backing these loans was 773 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 66% (at origination). At September 30, 2016, these loans were comprised of 99.5% fixed-rate loans with a weighted average coupon of 4.13%, and the remainder were hybrid or ARM loans with a

weighted average coupon of 3.83%.

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REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 6. Residential Loans - (continued)

At Consolidated Sequoia Entities

At September 30, 2016, we owned 3,901 held-for-investment loans at consolidated Sequoia entities, with an aggregate unpaid principal balance of \$943 million and a fair value of \$840 million, as compared to 4,545 loans at December 31, 2015, with an aggregate unpaid principal balance of \$1.12 billion and a fair value of \$1.02 billion. At origination, the weighted average FICO score of borrowers backing these loans was 728, the weighted average LTV ratio of these loans was 66%, and the loans were nearly all first lien and prime-quality.

At September 30, 2016 and December 31, 2015, the unpaid principal balance of loans at consolidated Sequoia entities delinquent greater than 90 days was \$19 million and \$27 million, respectively, and the unpaid principal balance of loans in foreclosure was \$18 million and \$32 million, respectively. During the three and nine months ended September 30, 2016, we recorded a net market valuation gain of \$9 million and a net market valuation loss of \$19 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income. During the three and nine months ended September 30, 2015, we recorded a net market valuation loss of \$0.4 million and a net market valuation gain of \$5 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income.

Note 7. Commercial Loans

We invest in commercial loans that we historically originated or acquired. In February 2016, we ceased originating commercial loans and in June 2016, we engaged a broker to sell our commercial loan portfolio. As a result, we reclassified most of our loans from held-for-investment to held-for-sale. As discussed further below, during the third quarter of 2016, we sold a significant portion of our commercial loans. The following table summarizes the classifications and carrying value of commercial loans at September 30, 2016 and December 31, 2015.

Table 7.1 – Classifications and Carrying Value of Commercial Loans

| (In Thousands)                 | September 30, December 31, |            |
|--------------------------------|----------------------------|------------|
|                                | 2016                       | 2015       |
| Held-for-sale                  |                            |            |
| At fair value                  | \$ —                       | \$ 39,141  |
| At lower of cost or fair value | 30,400                     | —          |
| Held-for-investment            |                            |            |
| At fair value                  | —                          | 67,657     |
| At amortized cost              | —                          | 295,849    |
| Total Commercial Loans         | \$ 30,400                  | \$ 402,647 |

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

Commercial Loans Held-for-Sale

At Fair Value

In June 2016, we transferred commercial mezzanine loans with an unpaid principal balance of \$67 million and a carrying value of \$70 million from held-for-investment at fair value to held-for-sale at fair value. During the third quarter of 2016, we sold all of our remaining commercial loans held-for-sale at fair value.

At December 31, 2015, commercial loans held-for-sale at fair value included four senior commercial mortgage loans with an aggregate outstanding principal balance of \$39 million and an aggregate fair value of \$39 million. During the three months ended September 30, 2016, we did not acquire or sell any senior commercial mortgage loans and we did not record any market valuation gains or losses on senior commercial mortgage loans. During the nine months ended September 30, 2016, we acquired \$38 million (principal balance) of senior commercial loans for which we elected the

fair value option and sold \$76 million (principal balance) of loans to third parties. During the nine months ended September 30, 2016, we recorded \$0.4 million of net market valuation gains on senior commercial mortgage loans, for which we elected the fair value option, through Mortgage banking activities, net on our consolidated statements of income.

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REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 7. Commercial Loans - (continued)

During the three and nine months ended September 30, 2015, we acquired \$168 million and \$518 million (principal balance), respectively, of senior commercial loans for which we elected the fair value option and sold \$254 million and \$602 million (principal balance), respectively, of loans to third parties. During the three and nine months ended September 30, 2015, we recorded \$4 million and \$11 million, respectively, of net market valuation gains on senior commercial mortgage loans for which we elected the fair value option through Mortgage banking activities, net on our consolidated statements of income.

At Lower of Cost or Fair Value

Commercial loans held-for-sale at the lower of cost or fair value primarily include mezzanine loans that are secured by a borrower's ownership interest in a single purpose entity that owns commercial property. At September 30, 2016, we held six commercial loans at the lower of cost or fair value with \$31 million in outstanding principal balance, a carrying value of \$30 million, and an estimated net fair value of \$32 million.

In June 2016, we transferred loans with an unpaid principal balance of \$237 million and a carrying value of \$233 million from held-for-investment at amortized cost to held-for-sale at the lower of cost or fair value, resulting from our decision to sell these loans. As we determined that the fair value of these loans was greater than their carrying value, we recorded the loans at their then current amortized cost, eliminating \$4 million of net purchase discount and establishing a valuation adjustment of \$4 million.

During the third quarter of 2016, we entered into an agreement with a third party to sell most of our remaining commercial mezzanine loans and, as of September 30, 2016, had completed the sale of loans with a principal balance of \$203 million, which resulted in gains of \$5 million that are presented in Realized gains, net on our consolidated statements of income. At September 30, 2016, we held six loans, of which five are pending sale pursuant to the sale agreement entered into during the third quarter of 2016, subject to the satisfaction of certain conditions. The remaining loan had a carrying value of \$3 million at September 30, 2016, and during the third quarter of 2016, this loan experienced a technical default and we recorded a valuation adjustment of \$0.3 million through Investment fair value changes, net, a component of our consolidated statements of income.

Commercial Loans Held-for-Investment

At Amortized Cost

Commercial loans held-for-investment include mezzanine loans that are secured by a borrower's ownership interest in a single purpose entity that owns commercial property. As described above, in June 2016, we transferred most of our held for investment loans to held-for-sale. The following table provides additional information for our commercial loans held-for-investment at amortized cost at September 30, 2016 and December 31, 2015.

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

| (In Thousands)            | September 30, December 31, |             |
|---------------------------|----------------------------|-------------|
|                           | 2016                       | 2015        |
| Principal balance         | \$                         | —\$ 307,047 |
| Unamortized discount, net | —                          | (4,096 )    |
| Recorded investment       | —                          | 302,951     |
| Allowance for loan losses | —                          | (7,102 )    |
| Carrying Value            | \$                         | —\$ 295,849 |

At September 30, 2016 and December 31, 2015, we held zero and 59 commercial loans held-for-investment at amortized cost, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 7. Commercial Loans - (continued)

Allowance for Loan Losses on Commercial Loans

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

During the second quarter of 2016, we transferred most of our held-for-investment loans to held-for-sale and recorded a reversal of provision for loan losses. This was based on our determination that the fair market value of these loans was higher than their amortized cost basis. As such, no valuation adjustment for the held-for-sale loans was charged against the allowance for loan losses during that quarter and the previously outstanding allowance associated with these loans was eliminated and a reversal of provision for loan losses was recorded in the second quarter of 2016. During the third quarter of 2016, our remaining commercial loans held-for-investment were repaid in full and, as result, we reversed our remaining provision for loan losses. The following table presents the principal balance of commercial loans held-for-investment by risk category.

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

| (In Thousands)                             | September 30, December 31, |             |
|--|----------------------------|-------------|
|  | 2016                       | 2015        |
| Pass                                       | \$                         | —\$ 272,768 |
| Watch list                                 | —                          | 34,279      |
| Workout                                    | —                          | —           |
| Total Commercial Loans Held-for-Investment | \$                         | —\$ 307,047 |

The following table summarizes the activity in the allowance for commercial loan losses for the three and nine months ended September 30, 2016 and 2015.

Table 7.4 – Activity in the Allowance for Commercial Loan Losses

| (In Thousands)                        | Three Months  |               | Nine Months   |               |
|---------------------------------------|---------------|---------------|---------------|---------------|
|                                       | Ended         |               | Ended         |               |
|                                       | September 30, | September 30, | September 30, | September 30, |
|                                       | 2016          | 2015          | 2016          | 2015          |
| Balance at beginning of period        | \$859         | \$7,401       | \$7,102       | \$7,456       |
| Reversal of provision for loan losses | (859 )        | (60 )         | (7,102 )      | (115 )        |
| Balance at End of Period              | \$—           | \$7,341       | \$—           | \$7,341       |

At December 31, 2015, all of our commercial loans collectively evaluated for impairment were current.

The following table summarizes the balances for loans collectively evaluated for impairment at September 30, 2016 and December 31, 2015.

Table 7.5 – Loans Collectively Evaluated for Impairment Review

| (In Thousands)      | September 30, December 31, |             |
|---------------------|----------------------------|-------------|
|                     | 2016                       | 2015        |
| Principal balance   | \$                         | —\$ 307,047 |
| Recorded investment | —                          | 302,951     |
| Related allowance   | —                          | 7,102       |

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Note 8. Real Estate Securities

We invest in real estate securities. The following table presents the fair values of our real estate securities by type at September 30, 2016 and December 31, 2015.

Table 8.1 – Fair Values of Real Estate Securities by Type

| (In Thousands)               | September 30, December 31, |              |
|------------------------------|----------------------------|--------------|
|                              | 2016                       | 2015         |
| Trading                      | \$ 341,269                 | \$ 404,011   |
| Available-for-sale           | 595,641                    | 829,245      |
| Total Real Estate Securities | \$ 936,910                 | \$ 1,233,256 |

Our real estate securities include mortgage backed securities, which are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior security interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior security interests, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests. We further separate our subordinate securities into mezzanine and subordinate, where mezzanine includes securities initially rated AA through BBB- and issued in 2012 or later.

Trading Securities

The following table presents the fair value of trading securities by collateral type at September 30, 2016 and December 31, 2015.

Table 8.2 – Trading Securities by Collateral Type

| (In Thousands)               | September 30, December 31, |            |
|------------------------------|----------------------------|------------|
|                              | 2016                       | 2015       |
| Senior Securities            |                            |            |
| Prime                        | \$ 19,098                  | \$ 248,570 |
| Non-prime                    | 5,394                      | 5,781      |
| Total Senior Securities      | 24,492                     | 254,351    |
| Subordinate Securities       |                            |            |
| Prime mezzanine              | 194,832                    | 136,140    |
| Prime subordinate            | 121,945                    | 13,520     |
| Total Subordinate Securities | 316,777                    | 149,660    |
| Total Trading Securities     | \$ 341,269                 | \$ 404,011 |

We elected the fair value option for certain securities and classify them as trading securities. Our trading securities are primarily comprised of residential mortgage backed securities.

At September 30, 2016 and December 31, 2015, our senior trading securities included \$24 million and \$37 million, respectively, of interest-only securities, for which there is no principal balance, and the remaining unpaid principal balance of our senior trading securities was zero and \$217 million, respectively, and our subordinate trading securities had an unpaid principal balance of \$332 million and \$168 million, respectively.

At September 30, 2016 and December 31, 2015, subordinate trading securities included \$134 million and \$48 million, respectively, of Agency residential mortgage credit risk transfer (or "CRT") securities, \$12 million and \$259 million, respectively, of Sequoia securities, \$98 million and \$89 million, respectively, of other third party residential securities, and \$73 million and \$8 million, respectively, of third-party commercial mortgage backed securities.



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Note 8. Real Estate Securities - (continued)

During the three and nine months ended September 30, 2016, we acquired \$65 million and \$198 million (principal balance), respectively, of senior and subordinate securities for which we elected the fair value option and classified as trading, and sold \$2 million and \$238 million, respectively, of such securities. During the three and nine months ended September 30, 2015, we acquired \$9 million and \$103 million (principal balance), respectively, of senior and subordinate securities for which we elected the fair value option and classified as trading, and sold \$2 million and \$81 million, respectively, of such securities.

During the three and nine months ended September 30, 2016, we recorded net market valuation gains of \$9 million and \$5 million, respectively, on trading securities, included in Investment fair value changes, net and Mortgage banking activities, net on our consolidated statements of income. During the three and nine months ended September 30, 2015, we recorded net market valuation losses of \$9 million and \$16 million, respectively, on trading securities, included in Investment fair value changes, net and Mortgage banking activities, net on our consolidated statements of income.

At September 30, 2016, trading securities with a carrying value of \$126 million were pledged as collateral under short-term borrowing agreements. See Note 12 for additional information on short-term debt.

AFS Securities

The following table presents the fair value of our available-for-sale securities by collateral type at September 30, 2016 and December 31, 2015.

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

| (In Thousands)               | September 30,<br>2016 | December 31,<br>2015 |
|------------------------------|-----------------------|----------------------|
| Senior Securities            |                       |                      |
| Prime                        | \$ 63,469             | \$ 210,993           |
| Non-prime                    | 7,821                 | 68,258               |
| Total Senior Securities      | 71,290                | 279,251              |
| Re-REMIC Securities          | 161,234               | 165,064              |
| Subordinate Securities       |                       |                      |
| Prime mezzanine              | 177,468               | 224,624              |
| Prime subordinate            | 185,649               | 160,306              |
| Total Subordinate Securities | 363,117               | 384,930              |
| Total AFS Securities         | \$ 595,641            | \$ 829,245           |

At September 30, 2016 and December 31, 2015, all of our available-for-sale securities were comprised of non-Agency residential mortgage backed securities. At September 30, 2016, AFS securities with a carrying value of \$210 million were pledged as collateral under short-term borrowing agreements. See Note 12 for additional information on short-term debt.

During the three and nine months ended September 30, 2016, we purchased \$11 million and \$29 million of AFS securities, respectively, and sold \$26 million and \$241 million of AFS securities, respectively, which resulted in net realized gains of \$2 million and \$20 million, respectively. During the three and nine months ended September 30, 2015, we purchased zero and \$15 million of AFS securities, respectively, and sold \$35 million and \$237 million of AFS securities, respectively, which resulted in net realized gains of \$4 million and \$14 million, respectively.

We often purchase AFS securities at a discount to their outstanding principal balances. To the extent we purchase an AFS security that has a likelihood of incurring a loss, we do not amortize into income the portion of the purchase discount that we do not expect to collect due to the inherent credit risk of the security. We may also expense a portion

of our investment in the security to the extent we believe that principal losses will exceed the purchase discount. We designate any amount of unpaid principal balance that we do not expect to receive and thus do not expect to earn or recover as a credit reserve on the security. Any remaining net unamortized discounts or premiums on the security are amortized into income over time using the effective yield method.

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Note 8. Real Estate Securities - (continued)

At September 30, 2016, there were \$1 million of AFS securities with contractual maturities less than five years, \$1 million with contractual maturities greater than five years but less than 10 years, and the remainder of our AFS securities had contractual maturities greater than 10 years.

The following table presents the components of carrying value (which equals fair value) of AFS securities at September 30, 2016 and December 31, 2015.

Table 8.4 – Carrying Value of AFS Securities

| September 30, 2016<br>(In Thousands) | Senior    |           |            |             |  | Total      |
|--------------------------------------|-----------|-----------|------------|-------------|--|------------|
|                                      | Prime     | Non-prime | Re-REMIC   | Subordinate |  |            |
| Principal balance                    | \$68,288  | \$ 9,372  | \$ 180,754 | \$ 460,981  |  | \$719,395  |
| Credit reserve                       | (1,483 )  | (641 )    | (10,452 )  | (35,037 )   |  | (47,613 )  |
| Unamortized discount, net            | (6,116 )  | (1,635 )  | (59,146 )  | (135,829 )  |  | (202,726 ) |
| Amortized cost                       | 60,689    | 7,096     | 111,156    | 290,115     |  | 469,056    |
| Gross unrealized gains               | 4,860     | 725       | 50,078     | 74,041      |  | 129,704    |
| Gross unrealized losses              | (2,080 )  | —         | —          | (1,039 )    |  | (3,119 )   |
| Carrying Value                       | \$63,469  | \$ 7,821  | \$ 161,234 | \$ 363,117  |  | \$595,641  |
| December 31, 2015<br>(In Thousands)  | Senior    |           |            |             |  | Total      |
|                                      | Prime     | Non-prime | Re-REMIC   | Subordinate |  |            |
| Principal balance                    | \$217,605 | \$ 75,591 | \$ 189,782 | \$ 490,249  |  | \$973,227  |
| Credit reserve                       | (1,305 )  | (5,101 )  | (10,332 )  | (32,131 )   |  | (48,869 )  |
| Unamortized discount, net            | (22,079 ) | (8,395 )  | (71,670 )  | (134,963 )  |  | (237,107 ) |
| Amortized cost                       | 194,221   | 62,095    | 107,780    | 323,155     |  | 687,251    |
| Gross unrealized gains               | 20,263    | 6,249     | 57,284     | 63,205      |  | 147,001    |
| Gross unrealized losses              | (3,491 )  | (86 )     | —          | (1,430 )    |  | (5,007 )   |
| Carrying Value                       | \$210,993 | \$ 68,258 | \$ 165,064 | \$ 384,930  |  | \$829,245  |

The following table presents the changes for the three and nine months ended September 30, 2016, in unamortized discount and designated credit reserves on residential AFS securities.

Table 8.5 – Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

| (In Thousands)                                 | Three Months Ended<br>September 30, 2016 |                                 | Nine Months Ended<br>September 30, 2016 |                                 |
|--|--|---------------------------------|---|---------------------------------|
|  | Credit<br>Reserve                        | Unamortized<br>Discount,<br>Net | Credit<br>Reserve                       | Unamortized<br>Discount,<br>Net |
| Beginning balance                              | \$44,943                                 | \$ 207,574                      | \$48,869                                | \$ 237,107                      |
| Amortization of net discount                   | —  | (6,124 )                        | —                                       | (20,531 )                       |
| Realized credit losses                         | (329 )                                   | —                               | (3,397 )                                | —                               |
| Acquisitions                                   | 2,136                                    | 2,982                           | 7,381                                   | 9,018                           |
| Sales, calls, other                            | —  | (843 )                          | (4,382 )                                | (24,031 )                       |
| Impairments                                    | —  | —                               | 305                                     | —                               |
| Transfers to (release of) credit reserves, net | 863                                      | (863 )                          | (1,163 )                                | 1,163                           |
| Ending Balance                                 | \$47,613                                 | \$ 202,726                      | \$47,613                                | \$ 202,726                      |



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Note 8. Real Estate Securities - (continued)

AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at September 30, 2016 and December 31, 2015.

Table 8.6 – Components of Fair Value of Residential AFS Securities by Holding Periods

| (In Thousands)     | Less Than 12 Consecutive Months |                   |            | 12 Consecutive Months or Longer |                   |            |
|--------------------|---------------------------------|-------------------|------------|---------------------------------|-------------------|------------|
|                    | Amortized Cost                  | Unrealized Losses | Fair Value | Amortized Cost                  | Unrealized Losses | Fair Value |
| September 30, 2016 | \$3,117                         | \$ (127 )         | \$2,990    | \$67,091                        | \$ (2,992 )       | \$64,099   |
| December 31, 2015  | 87,718                          | (1,972 )          | 85,746     | 77,539                          | (3,035 )          | 74,504     |

At September 30, 2016, after giving effect to purchases, sales, and extinguishment due to credit losses, our consolidated balance sheet included 184 AFS securities, of which 15 were in an unrealized loss position and 12 were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2015, our consolidated balance sheet included 224 AFS securities, of which 32 were in an unrealized loss position and 15 were in a continuous unrealized loss position for 12 consecutive months or longer.

Evaluating AFS Securities for Other-than-Temporary Impairments

Gross unrealized losses on our AFS securities were \$3 million at September 30, 2016. We evaluate all securities in an unrealized loss position to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). At September 30, 2016, we did not intend to sell any of our AFS securities that were in an unrealized loss position, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity. We review our AFS securities that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent security performance and expected future performance of the underlying collateral.

For the three months ended September 30, 2016, we recognized no OTTI losses related to our AFS securities. For the nine months ended September 30, 2016, other-than-temporary impairments were \$3 million, of which \$0.3 million were recognized through our consolidated statements of income and \$2 million were recognized in Accumulated other comprehensive income, a component of our consolidated balance sheet. AFS securities for which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. In determining our estimate of cash flows for AFS securities we may consider factors such as structural credit enhancement, past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, which are informed by prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, and geographic concentrations, as well as general market assessments. Changes in our evaluation of these factors impacted the cash flows expected to be collected at the OTTI assessment date and were used to determine if there were credit-related adverse cash flows and if so, the amount of credit related losses. Significant judgment is used in both our analysis of the expected cash flows for our AFS securities and any determination of the credit loss component of OTTI.

The table below summarizes the significant valuation assumptions we used for our AFS securities in unrealized loss positions at September 30, 2016.

Table 8.7 – Significant Valuation Assumptions

| September 30, 2016 | Range for Securities |
|--------------------|----------------------|
|                    |                      |

Prepayment rates 8% - 20%  
Projected losses —~~6~~ 9%

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Note 8. Real Estate Securities - (continued)

The following table details the activity related to the credit loss component of OTTI (i.e., OTTI recognized through earnings) for AFS securities held at September 30, 2016 and 2015, for which a portion of an OTTI was recognized in other comprehensive income.

Table 8.8 – Activity of the Credit Component of Other-than-Temporary Impairments

| (In Thousands)   | Three Months    |          | Nine Months     |          |
|--|-----------------|----------|-----------------|----------|
|  | Ended September |          | Ended September |          |
|  | 30,             | 30,      | 30,             | 30,      |
|  | 2016            | 2015     | 2016            | 2015     |
| Balance at beginning of period                         | \$28,198        | \$32,696 | \$28,277        | \$33,849 |
| Additions  |                 |          |                 |          |
| Initial credit impairments                             | —               | 226      | 291             | 226      |
| Reductions   |                 |          |                 |          |
| Securities sold, or expected to sell                   | —               | —        | (261 )          | (348 )   |
| Securities with no outstanding principal at period end | —               | (446 )   | (109 )          | (1,251 ) |
| Balance at End of Period                               | \$28,198        | \$32,476 | \$28,198        | \$32,476 |

Gains and losses from the sale of AFS securities are recorded as Realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains and losses on sales and calls of AFS securities for the three and nine months ended September 30, 2016 and 2015.

Table 8.9 – Gross Realized Gains and Losses on AFS Securities

| (In Thousands)   | Three Months  |               | Nine Months     |               |
|--|---------------|---------------|-----------------|---------------|
|  | Ended         |               | Ended September |               |
|  | September 30, | September 30, | September 30,   | September 30, |
|  | 2016          | 2015          | 2016            | 2015          |
| Gross realized gains - sales                                   | \$1,990       | \$4,053       | \$22,395        | \$14,315      |
| Gross realized gains - calls                                   | —             | 1,607         | 1,210           | 1,967         |
| Gross realized losses - sales                                  | —             | —             | (2,293 )        | —             |
| Gross realized losses - calls                                  | —             | (112 )        | —               | (112 )        |
| Total Realized Gains on Sales and Calls of AFS Securities, net | \$1,990       | \$5,548       | \$21,312        | \$16,170      |

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Note 9. Mortgage Servicing Rights

We invest in mortgage servicing rights associated with residential mortgage loans and contract with licensed sub-servicers to perform all servicing functions for these loans. The following table presents the fair value of MSR and the aggregate principal amounts of associated loans at September 30, 2016 and December 31, 2015.

Table 9.1 – Fair Value of MSRs and Aggregate Principal Amounts of Associated Loans

| (In Thousands)                  | September 30, 2016 |                      | December 31, 2015 |                      |
|---------------------------------|--------------------|----------------------|-------------------|----------------------|
|                                 | MSR Fair Value     | Associated Principal | MSR Fair Value    | Associated Principal |
| Mortgage Servicing Rights       |                    |                      |                   |                      |
| Conforming Loans                | \$69,578           | \$8,422,222          | \$133,838         | \$12,560,533         |
| Jumbo Loans                     | 36,431             | 5,494,950            | 58,138            | 5,705,939            |
| Total Mortgage Servicing Rights | \$106,009          | \$13,917,172         | \$191,976         | \$18,266,472         |

The following table presents activity for MSRs for the three and nine months ended September 30, 2016 and 2015.

Table 9.2 – Activity for MSRs

| (In Thousands)                        | Three Months Ended |                    | Nine Months Ended  |                    |
|---------------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                       | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Balance at beginning of period        | \$110,046          | \$168,462          | \$191,976          | \$139,293          |
| Additions                             | 3,443              | 22,760             | 22,941             | 73,976             |
| Sales                                 | (8,860 )           | —                  | (38,419 )          | (18,206 )          |
| Changes in fair value due to:         |                    |                    |                    |                    |
| Changes in assumptions <sup>(1)</sup> | 7,085              | (23,786 )          | (52,723 )          | (18,653 )          |
| Other changes <sup>(2)</sup>          | (5,705 )           | (4,710 )           | (17,766 )          | (13,684 )          |
| Balance at End of Period              | \$106,009          | \$162,726          | \$106,009          | \$162,726          |

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

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

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Note 9. Mortgage Servicing Rights - (continued)

We make investments in MSR through the retention of servicing rights associated with the residential mortgage loans that we acquire and subsequently transfer to third parties or through the direct acquisition of MSRs sold by third parties. We hold our MSR investments at our taxable REIT subsidiary. The following table details the retention and purchase of MSRs during the three and nine months ended September 30, 2016.

Table 9.3 – MSR Additions

| (In Thousands)                 | Three Months Ended September 30, 2016 |                      | Nine Months Ended September 30, 2016 |                      |
|--------------------------------|---------------------------------------|----------------------|--------------------------------------|----------------------|
|                                | MSR Fair Value                        | Associated Principal | MSR Fair Value                       | Associated Principal |
| Jumbo MSR additions:           |                                       |                      |                                      |                      |
| From securitization            | \$1,971                               | \$328,227            | \$4,102                              | \$638,469            |
| From loan sales                | 21                                    | 3,510                | 145                                  | 21,002               |
| Total jumbo MSR additions      | 1,992                                 | 331,737              | 4,247                                | 659,471              |
| Conforming MSR additions:      |                                       |                      |                                      |                      |
| From loan sales                | \$—                                   | \$—                  | \$3,380                              | \$316,290            |
| From purchases                 | 1,451                                 | 216,544              | 15,314                               | 1,629,762            |
| Total conforming MSR additions | 1,451                                 | 216,544              | 18,694                               | 1,946,052            |
| Total MSR Additions            | \$3,443                               | \$548,281            | \$22,941                             | \$2,605,523          |

The following table presents the components of our MSR income for the three and nine months ended September 30, 2016 and 2015.

Table 9.4 – Components of MSR Income (Loss), net

| (In Thousands)  | Three Months Ended September 30, |          | Nine Months Ended September 30, |           |
|---|----------------------------------|----------|---------------------------------|-----------|
|   | 2016                             | 2015     | 2016                            | 2015      |
| Servicing income  |                                  |          |                                 |           |
| Income  | \$9,943                          | \$10,028 | \$32,199                        | \$28,199  |
| Cost of sub-servicer  | (1,217)                          | (1,313)  | (4,958)                         | (3,704)   |
| Net servicing income  | 8,726                            | 8,715    | 27,241                          | 24,495    |
| Market valuation changes of MSRs                                  | 1,380                            | (28,496) | (70,489)                        | (32,337)  |
| Market valuation changes of associated derivatives <sup>(1)</sup> | (6,336)                          | 23,551   | 55,874                          | 1,736     |
| MSR provision for repurchases                                     | —                                | (221)    | 208                             | (439)     |
| MSR Income (Loss), Net  | \$3,770                          | \$3,549  | \$12,834                        | \$(6,545) |

<sup>(1)</sup> In the second quarter of 2015, we began to identify specific derivatives used to hedge the exposure of our MSRs to changes in market interest rates. See Note 2 for additional detail.

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Note 10. Derivative Financial Instruments

The following table presents the fair value and notional amount of our derivative financial instruments at September 30, 2016 and December 31, 2015.

Table 10.1 – Fair Value and Notional Amount of Derivative Financial Instruments

| (In Thousands)                                     | September 30, 2016 |                     | December 31, 2015 |                     |
|--|--------------------|---------------------|-------------------|---------------------|
|  | Fair Value         | Notional Amount     | Fair Value        | Notional Amount     |
| <b>Assets - Risk Management Derivatives</b>        |                    |                     |                   |                     |
| Interest rate swaps                                | \$ 16,839          | \$ 580,000          | \$ 2,590          | \$ 658,000          |
| TBA's  | 1,514              | 555,000             | 2,734             | 1,028,500           |
| Futures  | 257                | 130,000             | —                 | —                   |
| Swaptions  | 12,234             | 495,000             | 5,191             | 925,000             |
| Credit default index swaps                         | —                  | —                   | 1,207             | 25,000              |
| <b>Assets - Other Derivatives</b>                  |                    |                     |                   |                     |
| Loan purchase commitments                          | 6,036              | 892,901             | 4,671             | 764,161             |
| <b>Total Assets</b>                                | <b>\$ 36,880</b>   | <b>\$ 2,652,901</b> | <b>\$ 16,393</b>  | <b>\$ 3,400,661</b> |
| <b>Liabilities - Cash Flow Hedges</b>              |                    |                     |                   |                     |
| Interest rate swaps                                | \$(70,672)         | \$ 139,500          | \$(48,232)        | \$ 139,500          |
| <b>Liabilities - Risk Management Derivatives</b>   |                    |                     |                   |                     |
| Interest rate swaps                                | (24,499)           | 966,500             | (10,134)          | 1,039,500           |
| TBA's  | (4,335)            | 1,000,000           | (2,519)           | 1,450,500           |
| Futures  | (54)               | 15,000              | (445)             | 78,000              |
| <b>Liabilities - Other Derivatives</b>             |                    |                     |                   |                     |
| Loan purchase commitments                          | (557)              | 219,300             | (1,464)           | 375,815             |
| <b>Total Liabilities</b>                           | <b>\$(100,117)</b> | <b>\$ 2,340,300</b> | <b>\$(62,794)</b> | <b>\$ 3,083,315</b> |
| <b>Total Derivative Financial Instruments, Net</b> | <b>\$(63,237)</b>  | <b>\$ 4,993,201</b> | <b>\$(46,401)</b> | <b>\$ 6,483,976</b> |

**Risk Management Derivatives**

To manage, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheet, we may enter into derivative contracts. At September 30, 2016, we were party to swaps and swaptions with an aggregate notional amount of \$2.04 billion, TBA agreements sold with an aggregate notional amount of \$1.56 billion, and financial futures contracts with an aggregate notional amount of \$145 million. At December 31, 2015, we were party to swaps and swaptions with an aggregate notional amount of \$2.62 billion, TBA contracts sold with an aggregate notional amount of \$2.48 billion, and financial futures contracts with an aggregate notional amount of \$78 million. During the three and nine months ended September 30, 2016, we recorded net market valuation losses of \$5 million and \$11 million, respectively, on risk management derivatives. During the three and nine months ended September 30, 2015, we recorded net market valuation losses on risk management derivatives of \$29 million and \$58 million, respectively. These market valuation gains and losses are recorded in Mortgage banking activities, net, Investment fair value changes, net, and MSR income (loss), net on our consolidated statements of income.



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Note 10. Derivative Financial Instruments - (continued)

Loan Purchase and Forward Sale Commitments

LPCs and FSCs that qualify as derivatives are recorded at their estimated fair values. Net market valuation gains on LPCs and FSCs were \$12 million and \$36 million for the three and nine months ended September 30, 2016, respectively, and were \$25 million and \$44 million for the three and nine months ended September 30, 2015, respectively. The market valuation gains and losses were recorded in Mortgage banking activities, net on our consolidated statements of income.

Derivatives Designated as Cash Flow Hedges

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

For the three and nine months ended September 30, 2016, designated interest rate agreements had a net market valuation gain of \$1 million and a net market valuation loss of \$23 million, respectively, and were recorded in Accumulated other comprehensive income, a component of equity. For the three and nine months ended September 30, 2015, designated interest rate agreements had net market valuation losses of \$12 million and \$5 million, respectively. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in Accumulated other comprehensive income was \$70 million and \$47 million at September 30, 2016 and December 31, 2015, respectively.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and nine months ended September 30, 2016 and 2015.

Table 10.2 – Impact on Interest Expense of Interest Rate Agreements Accounted for as Cash Flow Hedges

|  | Three Months    |           | Nine Months     |           |
|--|-----------------|-----------|-----------------|-----------|
|  | Ended September |           | Ended September |           |
|  | 30,             | 30,       | 30,             | 2015      |
| (In Thousands)   | 2016            | 2015      | 2016            | 2015      |
| Net interest expense on cash flows hedges                        | \$(1,314)       | \$(1,466) | \$(4,049)       | \$(4,425) |
| Realized net losses reclassified from other comprehensive income | (18 )           | (19 )     | (55 )           | (77 )     |
| Total Interest Expense   | \$(1,332)       | \$(1,485) | \$(4,104)       | \$(4,502) |

Derivative Counterparty Credit Risk

As discussed in our Annual Report on Form 10-K for the year ended December 31, 2015, we consider counterparty risk as part of our fair value assessments of all derivative financial instruments at each quarter-end. At September 30, 2016, we assessed this risk as remote and did not record a specific valuation adjustment.

At September 30, 2016, we had outstanding derivative agreements with three counterparties (other than clearinghouses) and were in compliance with ISDA agreements governing our open derivative positions.

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Note 11. Other Assets and Liabilities

Other assets at September 30, 2016 and December 31, 2015, are summarized in the following table.

Table 11.1 – Components of Other Assets

| (In Thousands)   | September 30, December 31, |            |
|--|----------------------------|------------|
|  | 2016                       | 2015       |
| Margin receivable                                      | \$ 96,650                  | \$ 83,191  |
| Pledged collateral                                     | 43,802                     | 53,600     |
| FHLBC stock  | 43,393                     | 34,437     |
| REO  | 6,245                      | 4,896      |
| Guarantee asset  | 3,627                      | 5,697      |
| Fixed assets and leasehold improvements <sup>(1)</sup> | 2,850                      | 4,117      |
| Prepaid expenses                                       | 2,017                      | 3,640      |
| Investment receivable                                  | 1,525                      | 3,870      |
| Other  | 7,677                      | 4,438      |
| Total Other Assets                                     | \$ 207,786                 | \$ 197,886 |

<sup>(1)</sup> Fixed assets and leasehold improvements have a basis of \$5 million and accumulated depreciation of \$2 million at September 30, 2016.

Accrued expenses and other liabilities at September 30, 2016 and December 31, 2015 are summarized in the following table.

Table 11.2 – Components of Accrued Expenses and Other Liabilities

| (In Thousands)                              | September 30, December 31, |           |
|---|----------------------------|-----------|
|   | 2016                       | 2015      |
| Guarantee obligations                       | \$ 23,011                  | \$ 22,704 |
| Margin payable                              | 13,313                     | 6,415     |
| Accrued compensation                        | 12,674                     | 17,527    |
| Residential loan and MSR repurchase reserve | 6,617                      | 6,403     |
| Accrued operating expenses                  | 5,958                      | 1,845     |
| Restructuring liabilities                   | 3,667                      | —         |
| Legal reserve                               | 2,000                      | 2,000     |
| Current accounts payable                    | 1,292                      | 4,764     |
| Other                                       | 1,176                      | 8,239     |
| Total Other Liabilities                     | \$ 69,708                  | \$ 69,897 |

Margin Receivable and Payable

Margin receivable and payable resulted from margin calls between us and our counterparties under derivatives, master repurchase agreements, and warehouse facilities, whereby we or the counterparty posted collateral.

Guarantee Asset, Pledged Collateral, and Guarantee Obligations

The pledged collateral, guarantee asset, and guarantee obligations presented in the tables above are related to our risk sharing arrangements with Fannie Mae and Freddie Mac. In accordance with these arrangements, we are required to pledge collateral to secure our guarantee obligations. See Note 15 for additional information on our risk sharing arrangements.

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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(Unaudited)

Note 11. Other Assets and Liabilities - (continued)

Investment Receivable and Unsettled Trades

In accordance with our policy to record purchases and sales of securities on the trade date, if the trade and settlement of a purchase or sale crosses over a quarterly reporting period, we will record an investment receivable for sales and an unsettled trades liability for purchases.

REO

The carrying value of REO at September 30, 2016, was \$6 million, which includes the net effect of \$8 million related to transfers into REO during the nine months ended September 30, 2016, offset by \$9 million of REO liquidations, and \$2 million of unrealized gains resulting from market valuation adjustments. At September 30, 2016 and December 31, 2015, there were 24 and 23 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Sequoia entities.

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

Restructuring Accruals

In January 2016, we announced plans to restructure certain aspects of our residential mortgage loan operations by ceasing the acquisition and aggregation of conforming loans for resale to the Agencies. Additionally, in February 2016, we announced our plans to restructure our commercial business and no longer originate commercial loans. Finally, in March 2016, we announced the departure of our President effective July 1, 2016. These restructuring activities were substantially completed during the second quarter of 2016.

In connection with these activities, we incurred restructuring expenses, including one-time termination benefits, contract termination costs, and other associated costs. During the first quarter of 2016, we established a restructuring liability and recorded restructuring charges totaling \$11 million in Operating expenses on our consolidated statements of income, which included \$9 million of severance related charges (including \$3 million of equity compensation expense) and \$2 million of contract termination costs. During the second and third quarters of 2016, minor adjustments affected the restructuring accrual and we currently expect the remaining liabilities to be substantially settled during the next nine months in accordance with the terms of outstanding contracts and employment agreements. (See table below for more details). For segment reporting, we consider these restructuring charges as corporate charges and included them in the “corporate/other” reconciling column in our business segment financial information tables in Note 22, Segment Information.

The following table presents our restructuring activities and the associated liabilities during the three and nine months ended September 30, 2016.

Table 11.3 – Activities of Restructuring Liabilities

| (In Thousands)              | Three Months Ended September 30, 2016 |                            |                                 | Nine Months Ended September 30, 2016 |                            |                                 |
|-----------------------------|---------------------------------------|----------------------------|---------------------------------|--------------------------------------|----------------------------|---------------------------------|
|                             | Termination Benefits                  | Contract Termination Costs | Total Restructuring Liabilities | Termination Benefits                 | Contract Termination Costs | Total Restructuring Liabilities |
| Beginning balance           | \$3,387                               | \$ 772                     | \$ 4,159                        | \$—                                  | \$ —                       | \$ —                            |
| Costs incurred and expensed | —                                     | 4                          | 4                               | 8,793                                | 1,752                      | 10,545                          |
| Costs paid/settled          | (34 )                                 | (462 )                     | (496 )                          | (1,954 )                             | (1,438 )                   | (3,392 )                        |
| Adjustments <sup>(1)</sup>  | —                                     | —                          | —                               | (3,486 )                             | —                          | (3,486 )                        |
| Ending Balance              | \$3,353                               | \$ 314                     | \$ 3,667                        | \$3,353                              | \$ 314                     | \$ 3,667                        |

(1) Amount represents equity compensation expense recorded during the three and nine months ended September 30, 2016 related to equity awards that were accelerated, and will be distributed in future periods.

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REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 12. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At September 30, 2016, we had outstanding agreements with several counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q and in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015.

The table below summarizes the facilities that are available to us, the outstanding balances, the weighted average interest rate, and the maturity information of the short-term debt at September 30, 2016 and December 31, 2015.

Table 12.1 – Short-Term Debt Facilities

|                             |                      | September 30, 2016  |              |                                |                 |                                      |  |
|-----------------------------|----------------------|---------------------|--------------|--------------------------------|-----------------|--------------------------------------|--|
| (Dollars in Thousands)      | Number of Facilities | Outstanding Balance | Limit        | Weighted Average Interest Rate | Maturity        | Weighted Average Days Until Maturity |  |
| Residential loan warehouse  | 4                    | \$ 837,846          | \$ 1,325,000 | 2.07 %                         | 12/2016-8/2017  | 145                                  |  |
| Commercial loan warehouse   | 1                    | —                   | 150,000      | N/A                            | 10/2016         | N/A                                  |  |
| Real estate securities repo | 7                    | 279,559             | —            | 1.79 %                         | 10/2016-12/2016 | 26                                   |  |
| Total                       | 12                   | \$ 1,117,405        |              |                                |                 |                                      |  |
|                             |                      | December 31, 2015   |              |                                |                 |                                      |  |
| (Dollars in Thousands)      | Number of Facilities | Outstanding Balance | Limit        | Weighted Average Interest Rate | Maturity        | Weighted Average Days Until Maturity |  |
| Residential loan warehouse  | 4                    | \$ 950,022          | \$ 1,400,000 | 1.90 %                         | 2/2016-12/2016  | 182                                  |  |
| FHLBC <sup>(1)</sup>        | 1                    | 137,622             | —            | 0.21 %                         | 7/2016-11/2016  | 204                                  |  |
| Commercial loan warehouse   | 2                    | 73,718              | 300,000      | 4.13 %                         | 4/2016-10/2016  | 265                                  |  |
| Real estate securities repo | 9                    | 693,641             | —            | 1.47 %                         | 1/2016-3/2016   | 24                                   |  |
| Total                       | 16                   | \$ 1,855,003        |              |                                |                 |                                      |  |

Amount represents the portion of our borrowings from the FHLBC that were due within 12 months at (1)December 31, 2015. See Note 14 for additional information on our FHLB-member subsidiary's borrowing agreement with the FHLBC.

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At September 30, 2016, all of these borrowings were under uncommitted facilities and were due within 364 days (or less) of the borrowing date.

The fair value of held-for-sale residential loans, commercial loans, and real estate securities pledged as collateral was \$941 million, zero, and \$336 million, respectively, at September 30, 2016 and \$1.07 billion, \$152 million, and \$827 million, respectively, at December 31, 2015. For the three and nine months ended September 30, 2016, the average

balance of short-term debt was \$1.07 billion and \$1.15 billion, respectively. At September 30, 2016 and December 31, 2015, accrued interest payable on short-term debt was \$3 million and \$2 million, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 12. Short-Term Debt - (continued)

We also maintain a \$10 million committed line of credit with a financial institution that is secured by certain mortgage-backed securities with a fair market value of \$10 million at September 30, 2016. At both September 30, 2016 and December 31, 2015, we had no outstanding borrowings on this facility.

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of short-term debt by the type of collateral securing the debt at September 30, 2016.

Table 12.2 – Short-Term Debt by Collateral Type and Remaining Maturities

| (In Thousands)                  | September 30, 2016 |                  |                 | Total       |
|---------------------------------|--------------------|------------------|-----------------|-------------|
|                                 | Within<br>30 days  | 31 to 90<br>days | Over 90<br>days |             |
| Collateral Type                 |                    |                  |                 |             |
| Held-for-sale residential loans | \$—                | \$434,331        | \$403,515       | \$837,846   |
| Real estate securities          | 210,228            | 69,331           | —               | 279,559     |
| Total Short-Term Debt           | \$210,228          | \$503,662        | \$403,515       | \$1,117,405 |

Note 13. Asset-Backed Securities Issued

Through our Sequoia securitization program, we sponsor securitization transactions in which ABS backed by residential mortgage loans are issued by Sequoia entities. ABS were also issued by the Commercial Securitization and the Residential Resecuritization. During the second quarter of 2016, the debt of the Commercial Securitization was repaid. During the fourth quarter of 2015, the debt of the Residential Resecuritization was repaid. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 13. Asset-Backed Securities Issued - (continued)

The carrying values of ABS issued by consolidated securitization entities we sponsored at September 30, 2016 and December 31, 2015, along with other selected information, are summarized in the following table.

Table 13.1 – Asset-Backed Securities Issued

| (Dollars in Thousands)                              | September 30, 2016 |                              |            | December 31, 2015 |                              |             |
|---|--------------------|------------------------------|------------|-------------------|------------------------------|-------------|
|   | Sequoia            | Commercial<br>Securitization | Total      | Sequoia           | Commercial<br>Securitization | Total       |
| Certificates with principal balance                 | \$935,565          | \$ —                         | \$935,565  | \$1,108,785       | \$ 53,137                    | \$1,161,922 |
| Interest-only certificates                          | 4,383              | —                            | 4,383      | 4,672             | —                            | 4,672       |
| Market valuation adjustments                        | (120,080 )         | —                            | (120,080 ) | (116,637 )        | —                            | (116,637 )  |
| Total ABS issued                                    | 819,868            | —                            | 819,868    | 996,820           | 53,137                       | 1,049,957   |
| Deferred debt issuance costs                        | —                  | —                            | —          | —                 | (542 )                       | (542 )      |
| ABS Issued, Net <sup>(1)</sup>                      | \$819,868          | \$ —                         | \$819,868  | \$996,820         | \$ 52,595                    | \$1,049,415 |
| Range of weighted average interest rates, by series | 0.14% to<br>1.94%  | — %                          |            | 0.41% to<br>2.21% | 5.62 %                       |             |
| Stated maturities                                   | 2024 -<br>2036     | N/A                          |            | 2017 -<br>2037    | 2018                         |             |
| Number of series                                    | 20                 | —                            |            | 21                | 1                            |             |

<sup>(1)</sup> Upon adoption of ASU 2015-03 on January 1, 2016, we began to present ABS issued, net of deferred debt issuance costs. See Note 3 for further discussion.

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its stated maturity. At September 30, 2016, all outstanding ABS issued had contractual maturities beyond five years.

The following table summarizes the accrued interest payable on ABS issued at September 30, 2016 and December 31, 2015. Interest due on consolidated ABS issued is payable monthly.

Table 13.2 – Accrued Interest Payable on Asset-Backed Securities Issued

| (In Thousands)                               | September 30, December 31, |        |
|--|----------------------------|--------|
|  | 2016                       | 2015   |
| Sequoia                                      | \$ 523                     | \$ 555 |
| Commercial Securitization                    | —                          | 249    |
| Total Accrued Interest Payable on ABS Issued | \$ 523                     | \$ 804 |



REDWOOD TRUST, INC. AND SUBSIDIARIES  
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(Unaudited)

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

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at September 30, 2016 and December 31, 2015.

Table 13.3 – Collateral for Asset-Backed Securities Issued

| (In Thousands)                  | September 30, 2016 |                              |           | December 31, 2015 |                              |             |
|---------------------------------|--------------------|------------------------------|-----------|-------------------|------------------------------|-------------|
|                                 | Sequoia            | Commercial<br>Securitization | Total     | Sequoia           | Commercial<br>Securitization | Total       |
| Residential loans               | \$839,976          | \$ —                         | \$839,976 | \$1,021,870       | \$ —                         | \$1,021,870 |
| Commercial loans                | —                  | —                            | —         | —                 | 166,016                      | 166,016     |
| Restricted cash                 | 148                | —                            | 148       | 228               | 137                          | 365         |
| Accrued interest receivable     | 1,030              | —                            | 1,030     | 1,131             | 1,297                        | 2,428       |
| REO                             | 6,245              | —                            | 6,245     | 4,895             | —                            | 4,895       |
| Total Collateral for ABS Issued | \$847,399          | \$ —                         | \$847,399 | \$1,028,124       | \$ 167,450                   | \$1,195,574 |

Note 14. Long-Term Debt

FHLBC Borrowings

In July 2014, our FHLB-member subsidiary entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. At September 30, 2016, under this agreement, our subsidiary could incur borrowings up to \$2.00 billion, also referred to as “advances,” from the FHLBC secured by eligible collateral, including residential mortgage loans. During the three and nine months ended September 30, 2016, our FHLB-member subsidiary borrowed an additional zero and \$519 million, respectively, under this agreement. Under a final rule published by the Federal Housing Finance Agency in January 2016, our FHLB-member subsidiary will remain an FHLB member through the five-year transition period for captive insurance companies. Our FHLB-member subsidiary's existing \$2.00 billion of FHLB debt, which matures beyond this transition period, is permitted to remain outstanding until stated maturity. As residential loans pledged as collateral for this debt pay down, we are permitted to pledge additional loans or other eligible assets to collateralize this debt; however, we do not expect to be able to increase our subsidiary's FHLB debt above the existing \$2.00 billion maximum.

At September 30, 2016, \$2.00 billion of advances were outstanding under this agreement, which were classified as long-term debt, with a weighted average interest rate of 0.57% and a weighted average maturity of approximately nine years. At December 31, 2015, \$1.48 billion of advances were outstanding under this agreement, of which \$1.34 billion were classified as long-term debt, with a weighted average interest rate of 0.46% and a weighted average maturity of nine years. Advances under this agreement incur interest charges based on a specified margin over the FHLBC's 13-week discount note rate, which resets every 13 weeks. Total advances under this agreement were secured by residential mortgage loans with a fair value of \$2.27 billion at September 30, 2016. This agreement also requires our subsidiary to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of outstanding advances. At September 30, 2016, our subsidiary held \$43 million of FHLBC stock that is included in Other assets in our consolidated balance sheets.

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 14. Long-Term Debt - (continued)

The following table presents maturities of our FHLBC borrowings by year at September 30, 2016.

Table 14.1 – Maturities of FHLBC Borrowings by Year

| (In Thousands)         | September 30,<br>2016 |
|------------------------|-----------------------|
| 2024                   | \$ 470,171            |
| 2025                   | 887,639               |
| 2026                   | 642,189               |
| Total FHLBC Borrowings | \$ 1,999,999          |

For additional discussion of our FHLBC borrowings, see Part I, Item 2 of Quarterly Report on Form 10-Q under the heading “Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities.”

Commercial Secured Borrowings

At September 30, 2016 and December 31, 2015, we had zero and \$63 million of commercial secured borrowings, respectively, resulting from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. We bifurcated certain of our senior commercial mortgage loans into a senior portion that was sold to a third party and a junior portion that we retained as an investment. Although GAAP requires us to record a secured borrowing liability when we receive cash from selling the senior portion of the loan, the liability has no economic substance to us in that it does not require periodic interest payments and has no maturity. During the third quarter of 2016, we sold our retained junior portions of the loans we had originally bifurcated from these senior loans and derecognized the secured borrowing liability and the associated senior portion of the loan from our consolidated balance sheet.

Convertible Notes

In November 2014, RWT Holdings, Inc., a wholly-owned subsidiary of Redwood Trust, Inc., issued \$205 million principal amount of 5.625% exchangeable senior notes due 2019. These exchangeable notes require semi-annual interest payments at a fixed coupon rate of 5.625% until maturity or exchange, which will be no later than November 15, 2019. After deducting the underwriting discount and offering costs, we received \$198 million of net proceeds. Including amortization of deferred securities issuance costs, the weighted average interest expense yield on these exchangeable notes was approximately 6.6% per annum. At September 30, 2016, these notes were exchangeable at the option of the holder at an exchange rate of 46.1798 common shares per \$1,000 principal amount of exchangeable senior notes (equivalent to an exchange price of \$21.65 per common share). Upon exchange of these notes by a holder, the holder will receive shares of our common stock. During the three months ended September 30, 2016, we did not repurchase any of these notes. During the nine months ended September 30, 2016, we repurchased \$4 million par value of these notes at a discount and recorded a gain on extinguishment of debt of \$0.3 million in Realized gains, net on our consolidated statements of income. At September 30, 2016, the outstanding principal amount of these notes was \$201 million. At September 30, 2016, the accrued interest payable balance on this debt was \$5 million and the unamortized deferred issuance costs were \$4 million.

In March 2013, we issued \$288 million principal amount of 4.625% convertible senior notes due 2018. These convertible notes require semi-annual interest payments at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. After deducting the underwriting discount and offering costs, we received \$279 million of net proceeds. Including amortization of deferred securities issuance costs, the weighted average interest expense yield on these convertible notes was approximately 5.4% per annum. At September 30, 2016, the accrued interest payable balance on this debt was \$7 million and the unamortized deferred issuance costs were \$3 million. At September 30, 2016, these notes were convertible at the option of the holder at a conversion rate of 41.1320 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of

\$24.31 per common share). Upon conversion of these notes by a holder, the holder will receive shares of our common stock.

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Note 14. Long-Term Debt - (continued)

Trust Preferred Securities and Subordinated Notes

At September 30, 2016, we had trust preferred securities and subordinated notes outstanding of \$100 million and \$40 million, respectively. This debt requires quarterly interest payments at a floating rate equal to three-month LIBOR plus 2.25% until the debt is extinguished. Prior to 2014, we entered into interest rate swaps with aggregate notional values totaling \$140 million to hedge the variability in this long-term debt interest expense. Including hedging costs and amortization of deferred securities issuance costs, the weighted average interest expense yield on our trust preferred securities and subordinated notes was approximately 6.9% per annum.

At both September 30, 2016 and December 31, 2015, the accrued interest payable balance on our trust preferred securities and subordinated notes was \$1 million. Under the terms of this debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is pari passu or subordinate to this debt.

Note 15. Commitments and Contingencies

Lease Commitments

At September 30, 2016, we were obligated under five non-cancelable operating leases with expiration dates through 2021 for \$5 million of cumulative lease payments. Our operating lease expense was \$2 million for both the nine months ended September 30, 2016 and 2015.

The following table presents our future lease commitments at September 30, 2016.

Table 15.1 – Future Lease Commitments by Year

| (In Thousands)          | September 30,<br>2016 |
|-------------------------|-----------------------|
| 2016 (3 months)         | \$ 571                |
| 2017                    | 2,301                 |
| 2018                    | 1,268                 |
| 2019                    | 642                   |
| 2020                    | 581                   |
| 2021 and thereafter     | 48                    |
| Total Lease Commitments | \$ 5,411              |

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Note 15. Commitments and Contingencies - (continued)

## Loss Contingencies — Risk Sharing

At September 30, 2016, we had sold conforming loans to the Agencies with an original unpaid principal balance of \$3.19 billion, subject to our risk sharing arrangements with the Agencies. At September 30, 2016, the maximum potential amount of future payments we could be required to make under these arrangements was \$44 million and this amount was fully collateralized by assets we transferred to pledged accounts and is presented as pledged collateral in Other assets on our consolidated balance sheets. We have no recourse to any third parties that would allow us to recover any amounts related to our obligations under the arrangements. At September 30, 2016, we had not incurred any losses under these arrangements. For the three and nine months ended September 30, 2016, other income related to these arrangements was \$1 million and \$3 million, respectively. For the three and nine months ended September 30, 2015, other income related to these arrangements was \$0.2 million and \$2 million, respectively. For the three and nine months ended September 30, 2016, we recorded net market valuation losses of zero and \$1 million, respectively, related to these investments. For the three and nine months ended September 30, 2015, we recorded net market valuation losses of \$1 million and \$2 million, respectively, related to these investments.

All of the loans in the reference pools subject to these risk sharing arrangements were originated in 2014 and 2015, and at September 30, 2016, the loans had an unpaid principal balance of \$2.61 billion and a weighted average FICO score of 766 (at origination) and LTV of 74% (at origination). At September 30, 2016, \$1 million of the loans were 90 days or more delinquent, and \$1 million were in foreclosure. At September 30, 2016, the carrying value of our guarantee obligation was \$23 million and included \$10 million designated as a non-amortizing credit reserve, which we believe is sufficient to cover current expected losses under these obligations.

Our consolidated balance sheets include assets of special purpose entities ("SPEs") associated with these risk sharing arrangements (i.e., the "pledged collateral" referred to above) that can only be used to settle obligations of these SPEs for which the creditors of these SPEs (the Agencies) do not have recourse to Redwood Trust, Inc. or its affiliates. At September 30, 2016 and December 31, 2015, assets of such SPEs totaled \$50 million and \$63 million, respectively, and liabilities of such SPEs totaled \$23 million and \$25 million, respectively.

## Loss Contingencies — Residential Repurchase Reserve

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

At September 30, 2016 and December 31, 2015, our repurchase reserve associated with our residential loans and MSR was \$7 million and \$6 million, respectively, and was recorded in Accrued expenses and other liabilities on our consolidated balance sheets. We received 53 repurchase requests and we repurchased one loan during the nine months ended September 30, 2016. During the nine months ended September 30, 2016 and 2015, we recorded repurchase provisions of \$0.3 million and \$2 million, respectively, that were recorded in Mortgage banking activities, net and MSR income (loss), net on our consolidated statements of income and had charge-offs of \$0.1 million and zero, respectively.

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Note 15. Commitments and Contingencies - (continued)

Loss Contingencies — Litigation

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the “FHLB-Seattle”) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (“SRF”), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the “FHLB-Seattle Defendants”) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Seattle Certificate”) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the “2005-4 RMBS”) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys’ fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, at September 30, 2016, the FHLB-Seattle has received approximately \$122 million of principal and \$11 million of interest payments in respect of the Seattle Certificate. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. At the time the Seattle Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle’s claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (“Schwab”) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the “Schwab Defendants”) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. Schwab alleged only a claim for negligent misrepresentation under California state law against SRF and sought unspecified damages and attorneys’ fees and costs from SRF. Schwab claims that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Schwab Certificate”) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. On November 14, 2014, Schwab voluntarily dismissed with prejudice its negligent misrepresentation claim, which resulted in the dismissal with prejudice of SRF from the action. The Schwab Certificate was issued with an original principal amount of approximately \$15 million, and, at September 30, 2016, approximately \$14 million of principal and \$1 million of interest payments have been made in respect of the Schwab Certificate. At the time the Schwab Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named and remain as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.



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Note 15. Commitments and Contingencies - (continued)

Through certain of our wholly-owned subsidiaries, we have in the past engaged in, and expect to continue to engage in, activities relating to the acquisition and securitization of residential mortgage loans. In addition, certain of our wholly-owned subsidiaries have in the past engaged in activities relating to the acquisition and securitization of debt obligations and other assets through the issuance of collateralized debt obligations (commonly referred to as CDO transactions). Because of this involvement in the securitization and CDO businesses, we could become the subject of litigation relating to these businesses, including additional litigation of the type described above, and we could also become the subject of governmental investigations, enforcement actions, or lawsuits, and governmental authorities could allege that we violated applicable law or regulation in the conduct of our business. As an example, we recently became aware of a complaint filed by the State of California on April 1, 2016 against Morgan Stanley & Co. and certain of its affiliates alleging, among other things, that there were misleading statements contained in offering materials for 28 different mortgage pass-through certificates purchased by various California investors, including various California public pension systems, from Morgan Stanley and alleging that Morgan Stanley made false or fraudulent claims in connection with the sale of those certificates. Of the 28 mortgage pass-through certificates that are the subject of the complaint, two are Sequoia mortgage pass-through certificates issued in 2004 and two are Sequoia mortgage pass-through certificates issued in 2007, with respect to each of which certificates our wholly-owned subsidiary, RWT Holdings, Inc., was the sponsor and our wholly-owned subsidiary, Sequoia Residential Funding, Inc., was the depositor. At the time these four Sequoia mortgage pass-through certificates were issued, Sequoia Residential Funding, Inc. and Redwood Trust agreed to indemnify the underwriters of these certificates for certain losses and expenses they might incur as a result of claims made against them relating to these certificates, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At September 30, 2016, the aggregate amount of loss contingency reserves established in respect of the FHLB-Seattle and Schwab litigation matters described above was \$2 million. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

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

Future developments (including resolution of substantive pre-trial motions relating to these matters, receipt of additional information and documents relating to these matters (such as through pre-trial discovery), new or additional settlement communications with plaintiffs relating to these matters, or resolutions of similar claims against other defendants in these matters) could result in our concluding in the future to establish additional loss contingency reserves or to disclose an estimate of reasonably possible losses in excess of our established reserves with respect to



these matters. Our actual losses with respect to the above-referenced litigation matters may be materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters, including in the event that any of these matters proceeds to trial and the plaintiff prevails. Other factors that could result in our concluding to establish additional loss contingency reserves or estimate additional reasonably possible losses, or could result in our actual losses with respect to the above-referenced litigation matters being materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters include that: there are significant factual and legal issues to be resolved; information obtained or rulings made during the lawsuits could affect the methodology for calculation of the available remedies; and we may have additional obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters that could increase our potential losses.

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Note 16. Equity

The following table provides a summary of changes to accumulated other comprehensive income by component for the three and nine months ended September 30, 2016 and 2015.

Table 16.1 – Changes in Accumulated Other Comprehensive Income by Component

|   | Three Months Ended<br>September 30, 2016                          |  | Three Months Ended<br>September 30, 2015                          |  |
|---|---|--|---|--|
|   | Net<br>Unrealized<br>Gains on<br>Available-for-Sale<br>Securities | Net<br>Losses on<br>Interest Rate<br>Agreements<br>for as Cash<br>Flow<br>Hedges | Net<br>Unrealized<br>Gains on<br>Available-for-Sale<br>Securities | Net<br>Losses on<br>Interest Rate<br>Agreements<br>for as Cash<br>Flow<br>Hedges |
| (In Thousands)  |   |  |   |  |
| Balance at beginning of period                                      | \$116,849   | \$ (70,518 )   | \$179,659   | \$ (38,965 )   |
| Other comprehensive income (loss)<br>before reclassifications       | 9,038   | 647  | (5,673 )  | (12,049 )  |
| Amounts reclassified from other<br>accumulated comprehensive income | (1,319 )  | 18   | (3,270 )  | 19   |
| Net current-period other comprehensive income (loss)                | 7,719   | 665  | (8,943 )  | (12,030 )  |
| Balance at End of Period  | \$124,568   | \$ (69,853 )   | \$170,716   | \$ (50,995 )   |
|   | Nine Months Ended<br>September 30, 2016                           |  | Nine Months Ended<br>September 30, 2015                           |  |
|   | Net<br>Unrealized<br>Gains on<br>Available-for-Sale<br>Securities | Net<br>Losses on<br>Interest Rate<br>Agreements<br>for as Cash<br>Flow<br>Hedges | Net<br>Unrealized<br>Gains on<br>Available-for-Sale<br>Securities | Net<br>Losses on<br>Interest Rate<br>Agreements<br>for as Cash<br>Flow<br>Hedges |
| (In Thousands)  |   |  |   |  |
| Balance at beginning of period                                      | \$139,356   | \$ (47,363 )   | \$186,737   | \$ (46,049 )   |
| Other comprehensive income (loss)<br>before reclassifications       | 5,195   | (22,545 )  | (5,701 )  | (5,023 )   |
| Amounts reclassified from other<br>accumulated comprehensive income | (19,983 )   | 55   | (10,320 )   | 77   |
| Net current-period other comprehensive income (loss)                | (14,788 )   | (22,490 )  | (16,021 )   | (4,946 )   |
| Balance at End of Period  | \$124,568   | \$ (69,853 )   | \$170,716   | \$ (50,995 )   |

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 16. Equity - (continued)

The following table provides a summary of reclassifications out of accumulated other comprehensive income for three and nine months ended September 30, 2016 and 2015.

Table 16.2 – Reclassifications Out of Accumulated Other Comprehensive Income

| (In Thousands)   | Affected Line Item in the<br>Income Statement | Amount<br>Reclassified From<br>Accumulated<br>Other<br>Comprehensive<br>Income<br>Three Months<br>Ended September<br>30,<br>2016      2015 |            |
|--|---|--|------------|
| Net Realized (Gain) Loss on AFS Securities<br>Other than temporary impairment <sup>(1)</sup> | Investment fair value changes, net            | \$—  | \$198      |
| Gain on sale of AFS securities   | Realized gains, net                           | (1,319 )   | (3,468 )   |
|  |   | \$(1,319)  | \$(3,270)  |
| Net Realized Loss on Interest Rate<br>Agreements Designated as Cash Flow Hedges              |   |  |            |
| Amortization of deferred loss  | Interest expense                              | \$18   | \$19       |
|  |   | \$18   | \$19       |
| (In Thousands)   | Affected Line Item in the<br>Income Statement | Amount Reclassified<br>From Accumulated<br>Other<br>Comprehensive<br>Income<br>Nine Months Ended<br>September 30,<br>2016      2015        |            |
| Net Realized (Gain) Loss on AFS Securities<br>Other than temporary impairment <sup>(1)</sup> | Investment fair value changes, net            | \$305  | \$198      |
| Gain on sale of AFS securities   | Realized gains, net                           | (20,288 )  | (10,518 )  |
|  |   | \$(19,983)   | \$(10,320) |
| Net Realized Loss on Interest Rate<br>Agreements Designated as Cash Flow Hedges              |   |  |            |
| Amortization of deferred loss  | Interest expense                              | \$55   | \$77       |
|  |   | \$55   | \$77       |

For the three months ended September 30, 2016, there were no other-than-temporary impairments. For the nine months ended September 30, 2016, other-than-temporary impairments were \$3 million, of which \$0.3 million were recognized through our consolidated statements of income and \$2 million were recognized in Accumulated other comprehensive income, a component of our consolidated balance sheet.



REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 16. Equity - (continued)

Earnings per Common Share

The following table provides the basic and diluted earnings per common share computations for the three and nine months ended September 30, 2016 and 2015.

Table 16.3 – Basic and Diluted Earnings per Common Share

| (In Thousands, except Share Data)  | Three Months Ended    |            | Nine Months Ended     |            |
|--|-----------------------|------------|-----------------------|------------|
|  | September 30,<br>2016 | 2015       | September 30,<br>2016 | 2015       |
| Basic Earnings per Common Share:   |                       |            |                       |            |
| Net income attributable to Redwood   | \$52,553              | \$ 19,164  | \$105,897             | \$ 61,029  |
| Less: Dividends and undistributed earnings allocated to participating securities | (1,485 )              | (553 )     | (3,040 )              | (1,928 )   |
| Net income allocated to common shareholders                                      | \$51,068              | \$ 18,611  | \$102,857             | \$ 59,101  |
| Basic weighted average common shares outstanding                                 | 76,680,183            | 83,787,533 | 76,827,026            | 83,696,461 |
| Basic Earnings per Common Share  | \$0.67                | \$ 0.22    | \$1.34                | \$ 0.71    |
| Diluted Earnings per Common Share:   |                       |            |                       |            |
| Net income attributable to Redwood   | \$52,553              | \$ 19,164  | \$105,897             | \$ 61,029  |
| Less: Dividends and undistributed earnings allocated to participating securities | (1,439 )              | (553 )     | (3,226 )              | (1,928 )   |
| Add back: Interest expense on convertible notes for the period, net of tax       | 6,115                 | —          | 18,263                | —          |
| Net income allocated to common shareholders                                      | \$57,229              | \$ 18,611  | \$120,934             | \$ 59,101  |
| Weighted average common shares outstanding                                       | 76,680,183            | 83,787,533 | 76,827,026            | 83,696,461 |
| Net effect of dilutive equity awards   | 54,696                | 1,287,171  | 18,665                | 1,642,535  |
| Net effect of assumed convertible notes conversion to common shares              | 21,096,738            | —          | 21,145,987            | —          |
| Diluted weighted average common shares outstanding                               | 97,831,617            | 85,074,704 | 97,991,678            | 85,338,996 |
| Diluted Earnings per Common Share  | \$0.58                | \$ 0.22    | \$1.23                | \$ 0.69    |

We included participating securities, which are certain equity awards that have non-forfeitable dividend participation rights, in the calculations of basic and diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method for these shares. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances.

During the three and nine months ended September 30, 2016 and 2015, certain convertible notes were determined to be dilutive and were included in the calculation of diluted EPS under the "if-converted" method. Under this method, the periodic interest expense (net of applicable taxes) for dilutive notes is added back to the numerator and the number of shares that the notes are entitled to (if converted, regardless of whether they are in or out of the money) are included in the denominator.

For both the three and nine months ended September 30, 2016, no common shares related to the assumed conversion of the convertible notes were antidilutive and excluded in the calculation of diluted earnings per share. For both the three and nine months ended September 30, 2015, 21,292,309 of common shares related to the assumed conversion of the convertible notes were antidilutive and were excluded in the calculation of diluted earnings per share.

For the three and nine months ended September 30, 2016, the number of outstanding equity awards that were antidilutive totaled 6,623 and 6,565, respectively. For the three and nine months ended September 30, 2015, the number of outstanding equity awards that were antidilutive totaled 163,296 and 180,897, respectively.



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Note 16. Equity - (continued)

Stock Repurchases

In August 2015, our Board of Directors authorized the repurchase of up to \$100 million of our common stock. During the nine months ended September 30, 2016, we repurchased 839,130 common shares for \$11 million, utilizing the remaining availability under this authorization.

In February 2016, our Board of Directors approved an additional authorization for the repurchase of up to \$100 million of our common stock and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. This current authorization replaced all previous share repurchase plans and has no expiration date. This current repurchase authorization does not obligate us to acquire any specific number of shares or securities. Under this current authorization, shares or securities may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. Under this authorization, during the three and nine months ended September 30, 2016, we repurchased 259,005 shares and 1,078,743 shares, respectively, pursuant to this authorization for \$3 million and \$14 million, respectively. At September 30, 2016, approximately \$86 million of this current authorization remained available for the repurchase of shares of our common stock.

During both the three and nine months ended September 30, 2015, there were 2,451,523 shares acquired under then-existing share repurchase authorization.

Note 17. Equity Compensation Plans

At September 30, 2016 and December 31, 2015, 1,764,135 and 1,665,032 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled \$15 million at September 30, 2016, as shown in the following table.

Table 17.1 – Activities of Equity Compensation Costs by Award Type

| (In Thousands)  | Nine Months Ended September 30, 2016 |                      |                         |                              |           |
|---|--------------------------------------|----------------------|-------------------------|------------------------------|-----------|
|   | Restricted Stock                     | Deferred Stock Units | Performance Stock Units | Employee Stock Purchase Plan | Total     |
| Unrecognized compensation cost at beginning of period | \$2,393                              | \$14,392             | \$ 6,823                | \$ —                         | \$23,608  |
| Equity grants   | 1,753                                | 4,641                | —                       | 124                          | 6,518     |
| Equity grant forfeitures                              | (1,351 )                             | (1,167 )             | (2,209 )                | —                            | (4,727 )  |
| Equity compensation expense                           | (451 )                               | (7,922 )             | (2,134 )                | (93 )                        | (10,600 ) |
| Unrecognized Compensation Cost at End of Period       | \$2,344                              | \$9,944              | \$ 2,480                | \$ 31                        | \$14,799  |

At September 30, 2016, the weighted average amortization period remaining for all of our equity awards was less than two years.

Restricted Stock

At September 30, 2016 and December 31, 2015, there were 207,543 and 187,180 shares, respectively, of restricted stock outstanding. Restrictions on these shares lapse through 2020. During the nine months ended September 30, 2016, there were 144,056 shares of restricted stock granted, restrictions on 49,077 shares of restricted stock lapsed and those shares were distributed, and 74,616 shares of restricted stock awards forfeited.

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Note 17. Equity Compensation Plans - (continued)

Deferred Stock Units ("DSUs")

At September 30, 2016 and December 31, 2015, there were 2,033,395 and 2,407,154 DSUs, respectively, outstanding of which 1,247,119 and 1,363,548, respectively, had vested. There were 377,040 DSUs granted, 687,844 DSUs distributed, and 62,955 DSUs forfeited during the nine months ended September 30, 2016. Unvested DSUs at September 30, 2016 vest through 2020. During the first quarter of 2016, equity compensation expense of \$3 million was recognized in connection with the announced departures of two executives due to the full vesting of their DSUs in accordance with the terms of their employment agreements.

Performance Stock Units ("PSUs")

At September 30, 2016 and December 31, 2015, the target number of PSUs that were unvested was 656,725 and 849,021, respectively. PSUs do not vest until the third anniversary of their grant date, with the level of vesting at that time contingent on total stockholder return (defined as the change in our common stock price, adjusted to reflect the reinvestment of all dividends declared and/or paid on our common stock, relative to an average of the per share price of our common stock over a 40 trading day period preceding on the date of the PSU grant) over the three-year vesting period ("Three-Year TSR"). The number of underlying shares of our common stock that will vest during 2016 and in future years will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the target number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period.

During the first quarter of 2016, equity compensation expense of \$0.6 million was recognized in connection with the announced departures of two executives to reflect the pro-rated vesting of their PSUs through their departure dates in 2016 in accordance with the terms of their employment agreements.

Employee Stock Purchase Plan ("ESPP")

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. At September 30, 2016 and December 31, 2015, 329,736 and 310,040 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP at September 30, 2016.



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Note 18. Mortgage Banking Activities, Net

The following table presents the components of Mortgage banking activities, net, recorded in our consolidated statements of income for the three and nine months ended September 30, 2016 and 2015.

Table 18.1 – Mortgage Banking Activities

| (In Thousands)                                     | Three Months    |          | Nine Months     |          |
|--|-----------------|----------|-----------------|----------|
|  | Ended September |          | Ended September |          |
|  | 30,             | 30,      | 30,             | 30,      |
|  | 2016            | 2015     | 2016            | 2015     |
| Residential Mortgage Banking Activities, Net:      |                 |          |                 |          |
| Changes in fair value of:                          |                 |          |                 |          |
| Residential loans, at fair value <sup>(1)</sup>    | \$12,671        | \$36,183 | \$47,456        | \$54,375 |
| Sequoia securities                                 | —               | —        | 1,455           | (14,359) |
| Risk management derivatives <sup>(2)</sup>         | (3,287)         | (37,029) | (22,743)        | (35,842) |
| Other income (expense), net <sup>(3)</sup>         | 382             | 1,177    | 606             | 3,209    |
| Total residential mortgage banking activities, net | 9,766           | 331      | 26,774          | 7,383    |
| Commercial Mortgage Banking Activities, Net:       |                 |          |                 |          |
| Changes in fair value of:                          |                 |          |                 |          |
| Commercial loans, at fair value                    | —               | 3,974    | 433             | 10,819   |
| Risk management derivatives <sup>(2)</sup>         | —               | (3,081)  | (2,538)         | (7,832)  |
| Other fee income                                   | —               | 109      | 43              | 336      |
| Total commercial mortgage banking activities, net  | —               | 1,002    | (2,062)         | 3,323    |
| Mortgage Banking Activities, Net                   | \$9,766         | \$1,333  | \$24,712        | \$10,706 |

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

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 19. Investment Fair Value Changes, Net

The following table presents the components of Investment fair value changes, net, recorded in our consolidated statements of income for the three and nine months ended September 30, 2016 and 2015.

Table 19.1 – Investment Fair Value Changes

| (In Thousands)   | Three Months<br>Ended September<br>30, |            | Nine Months Ended<br>September 30, |            |
|--|--|------------|------------------------------------|------------|
|  | 2016                                   | 2015       | 2016                               | 2015       |
| Investment Fair Value Changes, Net                         |  |            |                                    |            |
| Changes in fair value of:                                  |  |            |                                    |            |
| Residential loans held-for-investment, at Redwood          | \$(655 )                               | \$9,077    | \$22,161                           | \$5,170    |
| Trading securities   | 8,898                                  | (8,784 )   | 3,728                              | (1,587 )   |
| Net investments in consolidated Sequoia entities           | (255 )                                 | (500 )     | (2,086 )                           | (2,277 )   |
| Risk sharing investments                                   | 15                                     | (1,098 )   | (689 )                             | (1,799 )   |
| Risk management derivatives                                | 4,222                                  | (12,638 )  | (41,188 )                          | (16,386 )  |
| Valuation adjustments on commercial loans<br>held-for-sale | (307 )                                 | —          | (307 )                             | —          |
| Impairments on AFS securities                              | —                                      | (226 )     | (305 )                             | (226 )     |
| Investment Fair Value Changes, Net                         | \$11,918                               | \$(14,169) | \$(18,686)                         | \$(17,105) |

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 20. Operating Expenses

Components of our operating expenses for the three and nine months ended September 30, 2016 and 2015 are presented in the following table.

Table 20.1 – Components of Operating Expenses

| (In Thousands)                                  | Three Months        |          | Nine Months         |          |
|---|---------------------|----------|---------------------|----------|
|   | Ended September 30, |          | Ended September 30, |          |
|   | 2016                | 2015     | 2016                | 2015     |
| Fixed compensation expense                      | \$5,253             | \$8,642  | \$19,022            | \$27,083 |
| Variable compensation expense                   | 5,802               | 3,567    | 11,824              | 11,135   |
| Equity compensation expense                     | 2,031               | 2,835    | 7,117               | 9,112    |
| Total compensation expense                      | 13,086              | 15,044   | 37,963              | 47,330   |
| Systems and consulting                          | 2,692               | 2,355    | 7,274               | 6,718    |
| Loan acquisition costs <sup>(1)</sup>           | 1,393               | 2,995    | 4,680               | 7,864    |
| Office costs                                    | 1,056               | 1,314    | 3,501               | 3,912    |
| Accounting and legal                            | 721                 | 1,047    | 3,043               | 3,754    |
| Corporate costs                                 | 478                 | 484      | 1,589               | 1,521    |
| Other operating expenses                        | 925                 | 1,258    | 2,367               | 3,679    |
| Operating expenses before restructuring charges | 20,351              | 24,497   | 60,417              | 74,778   |
| Restructuring charges <sup>(2)</sup>            | 4                   | —        | 10,545              | —        |
| Total Operating Expenses                        | \$20,355            | \$24,497 | \$70,962            | \$74,778 |

(1) Loan acquisition costs primarily includes underwriting and due diligence costs related to the acquisition of residential loans held-for-sale at fair value.

For the nine months ended September 30, 2016, restructuring charges included \$5 million of fixed compensation expense and \$4 million of equity compensation expense related to one-time termination benefits, as well as \$2 million of other contract termination costs, associated with the restructuring of our conforming and commercial mortgage banking operations and related charges associated with the departure of Redwood's President announced in the first quarter of 2016. See Note 11 for further discussion on restructuring charges.

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Note 21. Taxes

For the nine months ended September 30, 2016 and 2015, we recognized a provision for income taxes of \$1 million and a benefit from income taxes of \$10 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our effective tax rate at September 30, 2016 and 2015.

Table 21.1 – Reconciliation of Statutory Tax Rate to Effective Tax Rate

|   | September 30, 2016 |    | September 30, 2015 |    |
|---|--------------------|----|--------------------|----|
| Federal statutory rate                                | 34.0               | %  | 34.0               | %  |
| State statutory rate, net of Federal tax effect       | 7.2                | %  | 7.2                | %  |
| Differences in taxable (loss) income from GAAP income | (21.7)             | )% | (36.5)             | )% |
| Change in valuation allowance                         | 6.6                | %  | 20.9               | %  |
| Dividends paid deduction                              | (24.9)             | )% | (45.8)             | )% |
| Effective Tax Rate                                    | 1.2                | %  | (20.2)             | )% |

We assessed our tax positions for all open tax years (i.e., Federal, 2013 to 2016, and State, 2012- 2016) at September 30, 2016 and December 31, 2015, and concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

Note 22. Segment Information

Redwood operates in three segments: Residential Mortgage Banking, Residential Investments, and Commercial. Beginning in the first quarter of 2016, we renamed our former "Commercial mortgage banking and investments" segment to our "Commercial" segment, as a result of our announcement to discontinue the origination of commercial loans. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For a full description of our segments, see Item 1—Business in our Annual Report on Form 10-K for the year ended December 31, 2015.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
September 30, 2016  
(Unaudited)

Note 22. Segment Information - (continued)

The following tables present financial information by segment for the three and nine months ended September 30, 2016 and 2015.

Table 22.1 – Business Segment Financial Information

| (In Thousands)                            | Three Months Ended September 30, 2016 |                            |            |                     | Total     |
|---|---------------------------------------|----------------------------|------------|---------------------|-----------|
|   | Residential<br>Mortgage<br>Banking    | Residential<br>Investments | Commercial | Corporate/<br>Other |           |
| Interest income                           | \$8,831                               | \$ 39,981                  | \$ 7,195   | \$ 4,899            | \$60,906  |
| Interest expense                          | (3,826 )                              | (4,471 )                   | (542 )     | (12,758 )           | (21,597 ) |
| Net interest income (loss)                | 5,005                                 | 35,510                     | 6,653      | (7,859 )            | 39,309    |
| Reversal of provision for loan losses     | —                                     | —                          | 859        | —                   | 859       |
| Non-interest income                       |                                       |                            |            |                     |           |
| Mortgage banking activities, net          | 9,766                                 | —                          | —          | —                   | 9,766     |
| MSR income (loss), net                    | —                                     | 3,770                      | —          | —                   | 3,770     |
| Investment fair value changes, net        | —                                     | 11,973                     | 203        | (258 )              | 11,918    |
| Other income                              | —                                     | 1,643                      | —          | —                   | 1,643     |
| Realized gains, net                       | —                                     | 1,991                      | 4,624      | —                   | 6,615     |
| Total non-interest income, net            | 9,766                                 | 19,377                     | 4,827      | (258 )              | 33,712    |
| Direct operating expenses <sup>(1)</sup>  | (5,807 )                              | (2,498 )                   | (253 )     | (11,797 )           | (20,355 ) |
| Provision for income taxes                | (240 )                                | (732 )                     | —          | —                   | (972 )    |
| Segment Contribution                      | \$8,724                               | \$ 51,657                  | \$ 12,086  | \$ (19,914 )        |           |
| Net Income                                |                                       |                            |            |                     | \$52,553  |
| Non-cash amortization income (expense)    | \$(28 )                               | \$ 6,124                   | \$(1 )     | \$(983 )            | \$5,112   |
|   | Three Months Ended September 30, 2015 |                            |            |                     |           |
| (In Thousands)                            | Residential<br>Mortgage<br>Banking    | Residential<br>Investments | Commercial | Corporate/<br>Other | Total     |
| Interest income                           | \$12,115                              | \$ 34,074                  | \$ 11,191  | \$ 6,104            | \$63,484  |
| Interest expense                          | (4,313 )                              | (2,660 )                   | (3,502 )   | (13,400 )           | (23,875 ) |
| Net interest income (loss)                | 7,802                                 | 31,414                     | 7,689      | (7,296 )            | 39,609    |
| Reversal of provision for loan losses     | —                                     | —                          | 60         | —                   | 60        |
| Non-interest income                       |                                       |                            |            |                     |           |
| Mortgage banking activities, net          | 331                                   | —                          | 1,002      | —                   | 1,333     |
| MSR income (loss), net                    | —                                     | 3,549                      | —          | —                   | 3,549     |
| Investment fair value changes, net        | —                                     | (13,622 )                  | —          | (547 )              | (14,169 ) |
| Other income                              | —                                     | 327                        | —          | —                   | 327       |
| Realized gains, net                       | —                                     | 5,548                      | —          | —                   | 5,548     |
| Total non-interest income, net            | 331                                   | (4,198 )                   | 1,002      | (547 )              | (3,412 )  |
| Direct operating expenses                 | (11,278 )                             | (1,311 )                   | (3,136 )   | (8,772 )            | (24,497 ) |
| (Provision for) benefit from income taxes | 2,690                                 | 4,082                      | (389 )     | 1,021               | 7,404     |
| Segment Contribution                      | \$(455 )                              | \$ 29,987                  | \$ 5,226   | \$ (15,594 )        |           |
| Net Income                                |                                       |                            |            |                     | \$19,164  |

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|  |          |          |          |            |         |
|--|----------|----------|----------|------------|---------|
| Non-cash amortization income (expense) | \$(45 )  | \$ 9,115 | \$ (61 ) | \$(1,007 ) | \$8,002 |
| Hedging allocations                    | (1,683 ) | 1,683    | —        | —          | —       |

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REDWOOD TRUST, INC. AND SUBSIDIARIES  
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## Note 22. Segment Information - (continued)

| (In Thousands)                           | Nine Months Ended September 30, 2016 |                            |            |                     |            |
|--|--------------------------------------|----------------------------|------------|---------------------|------------|
|  | Residential<br>Mortgage<br>Banking   | Residential<br>Investments | Commercial | Corporate/<br>Other | Total      |
| Interest income                          | \$24,610                             | \$ 120,812                 | \$ 29,927  | \$ 14,672           | \$ 190,021 |
| Interest expense                         | (10,719 )                            | (14,076 )                  | (5,001 )   | (38,195 )           | (67,991 )  |
| Net interest income (loss)               | 13,891                               | 106,736                    | 24,926     | (23,523 )           | 122,030    |
| Reversal of provision for loan losses    | —                                    | —                          | 7,102      | —                   | 7,102      |
| Non-interest income                      |                                      |                            |            |                     |            |
| Mortgage banking activities, net         | 26,774                               | —                          | (2,062 )   | —                   | 24,712     |
| MSR income (loss), net                   | —                                    | 12,834                     | —          | —                   | 12,834     |
| Investment fair value changes, net       | —                                    | (16,913 )                  | 408        | (2,181 )            | (18,686 )  |
| Other income                             | —                                    | 4,130                      | 27         | —                   | 4,157      |
| Realized gains, net                      | —                                    | 21,312                     | 4,433      | 292                 | 26,037     |
| Total non-interest income, net           | 26,774                               | 21,363                     | 2,806      | (1,889 )            | 49,054     |
| Direct operating expenses <sup>(1)</sup> | (17,175 )                            | (6,517 )                   | (2,524 )   | (44,746 )           | (70,962 )  |
| Provision for income taxes               | (240 )                               | (1,087 )                   | —          | —                   | (1,327 )   |
| Segment Contribution                     | \$23,250                             | \$ 120,495                 | \$ 32,310  | \$ (70,158 )        |            |
| Net Income                               |                                      |                            |            |                     | \$105,897  |
| Non-cash amortization income (expense)   | \$(102 )                             | \$ 20,531                  | \$(24 )    | \$(2,978 )          | \$17,427   |
|  | Nine Months Ended September 30, 2015 |                            |            |                     |            |
| (In Thousands)                           | Residential<br>Mortgage<br>Banking   | Residential<br>Investments | Commercial | Corporate/<br>Other | Total      |
| Interest income                          | \$37,886                             | \$ 98,335                  | \$ 34,784  | \$ 19,598           | \$ 190,603 |
| Interest expense                         | (11,389 )                            | (8,137 )                   | (10,488 )  | (40,830 )           | (70,844 )  |
| Net interest income (loss)               | 26,497                               | 90,198                     | 24,296     | (21,232 )           | 119,759    |
| Reversal of provision for loan losses    | —                                    | —                          | 115        | —                   | 115        |
| Non-interest income                      |                                      |                            |            |                     |            |
| Mortgage banking activities, net         | 7,383                                | —                          | 3,323      | —                   | 10,706     |
| MSR income (loss), net                   | —                                    | (6,545 )                   | —          | —                   | (6,545 )   |
| Investment fair value changes, net       | —                                    | (14,745 )                  | —          | (2,360 )            | (17,105 )  |
| Other income                             | —                                    | 2,435                      | —          | —                   | 2,435      |
| Realized gains, net                      | —                                    | 16,170                     | —          | —                   | 16,170     |
| Total non-interest income, net           | 7,383                                | (2,685 )                   | 3,323      | (2,360 )            | 5,661      |
| Direct operating expenses                | (33,214 )                            | (3,600 )                   | (9,638 )   | (28,326 )           | (74,778 )  |
| Benefit from income taxes                | 3,562                                | 3,824                      | 321        | 2,565               | 10,272     |
| Segment Contribution                     | \$4,228                              | \$ 87,737                  | \$ 18,417  | \$ (49,353 )        |            |
| Net Income                               |                                      |                            |            |                     | \$61,029   |
| Non-cash amortization income (expense)   | \$(135 )                             | \$ 28,277                  | \$(188 )   | \$(2,984 )          | \$24,970   |
| Hedging allocations                      | 1,120                                | (1,070 )                   | —          | (50 )               | —          |

(1)

For the three and nine months ended September 30, 2016, charges associated with the restructuring of our conforming residential mortgage loan operations and commercial operations, included in the direct operating expense line item, are presented under the Corporate/Other column. See Note 11 for further discussion of these restructuring charges.



REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 22. Segment Information - (continued)

The following tables present the components of Corporate/Other for the three and nine months ended September 30, 2016 and 2015.

Table 22.2 – Components of Corporate/Other

| (In Thousands)                     | Three Months Ended September 30,<br>2016      |            |            | 2015  |            |            |
|------------------------------------|---|------------|------------|---|------------|------------|
|                                    | Legacy<br>Consolidated<br>VIEs <sup>(1)</sup> | Other      | Total      | Legacy<br>Consolidated<br>VIEs <sup>(1)</sup> | Other      | Total      |
| Interest income                    | \$4,837                                       | \$62       | \$4,899    | \$6,098                                       | \$6        | \$6,104    |
| Interest expense                   | (3,274)                                       | (9,484)    | (12,758)   | (3,842)                                       | (9,558)    | (13,400)   |
| Net interest income (loss)         | 1,563   | (9,422)    | (7,859)    | 2,256   | (9,552)    | (7,296)    |
| Non-interest income                |   |            |            |   |            |            |
| Investment fair value changes, net | (255)   | (3)        | (258)      | (501)   | (46)       | (547)      |
| Total non-interest income, net     | (255)   | (3)        | (258)      | (501)   | (46)       | (547)      |
| Direct operating expenses          | —   | (11,797)   | (11,797)   | —   | (8,772)    | (8,772)    |
| Provision for income taxes         | —   | —          | —          | —   | 1,021      | 1,021      |
| Total                              | \$1,308                                       | \$(21,222) | \$(19,914) | \$1,755                                       | \$(17,349) | \$(15,594) |
| (In Thousands)                     | Nine Months Ended September 30,<br>2016       |            |            | 2015  |            |            |
|                                    | Legacy<br>Consolidated<br>VIEs <sup>(1)</sup> | Other      | Total      | Legacy<br>Consolidated<br>VIEs <sup>(1)</sup> | Other      | Total      |
| Interest income                    | \$14,525                                      | \$147      | \$14,672   | \$19,578                                      | \$20       | \$19,598   |
| Interest expense                   | (9,842)                                       | (28,353)   | (38,195)   | (12,372)                                      | (28,458)   | (40,830)   |
| Net interest income (loss)         | 4,683   | (28,206)   | (23,523)   | 7,206   | (28,438)   | (21,232)   |
| Non-interest income                |   |            |            |   |            |            |
| Investment fair value changes, net | (2,086)                                       | (95)       | (2,181)    | (2,277)                                       | (83)       | (2,360)    |
| Realized gains, net                | —   | 292        | 292        | —   | —          | —          |
| Total non-interest income, net     | (2,086)                                       | 197        | (1,889)    | (2,277)                                       | (83)       | (2,360)    |
| Direct operating expenses          | —   | (44,746)   | (44,746)   | —   | (28,326)   | (28,326)   |
| Provision for income taxes         | —   | —          | —          | —   | 2,565      | 2,565      |
| Total                              | \$2,597                                       | \$(72,755) | \$(70,158) | \$4,929                                       | \$(54,282) | \$(49,353) |

(1) Legacy consolidated VIEs represent legacy Sequoia entities that are consolidated for GAAP financial reporting purposes. See Note 4 for further discussion on VIEs.

REDWOOD TRUST, INC. AND SUBSIDIARIES  
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Note 22. Segment Information - (continued)

The following table presents supplemental information by segment at September 30, 2016 and December 31, 2015.  
 Table 22.3 – Supplemental Segment Information

| (In Thousands)            | Residential<br>Mortgage<br>Banking | Residential<br>Investments | Commercial | Corporate/<br>Other | Total       |
|---------------------------|------------------------------------|----------------------------|------------|---------------------|-------------|
| September 30, 2016        |                                    |                            |            |                     |             |
| Residential loans         | \$1,188,514                        | \$2,282,674                | \$ —       | —\$839,976          | \$4,311,164 |
| Commercial loans          | —                                  | —                          | 30,400     | —                   | 30,400      |
| Real estate securities    | —                                  | 864,300                    | 72,610     | —                   | 936,910     |
| Mortgage servicing rights | —                                  | 106,009                    | —          | —                   | 106,009     |
| Total assets              | 1,215,240                          | 3,470,013                  | 103,507    | 1,083,859           | 5,872,619   |
| December 31, 2015         |                                    |                            |            |                     |             |
| Residential loans         | \$1,115,738                        | \$1,791,195                | \$ —       | —\$1,021,870        | \$3,928,803 |
| Commercial loans          | —                                  | —                          | 402,647    | —                   | 402,647     |
| Real estate securities    | 197,007                            | 1,028,171                  | 8,078      | —                   | 1,233,256   |
| Mortgage servicing rights | —                                  | 191,976                    | —          | —                   | 191,976     |
| Total assets              | 1,347,492                          | 3,140,604                  | 415,716    | 1,316,235           | 6,220,047   |

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

### INTRODUCTION

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

Overview

Results of Operations

Liquidity and Capital Resources

Off Balance Sheet Arrangements and Contractual Obligations

Critical Accounting Policies and Estimates

New Accounting Standards

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

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

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

## Our Business

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

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

During the first quarter of 2016, we announced a restructuring of our mortgage banking operations, whereby we would discontinue the acquisition of conforming residential loans and the origination of commercial loans. During the first quarter of 2016, we substantially completed the wind-down of these operations and at March 31, 2016, had sold all of our senior commercial mortgage loans and nearly all of our conforming residential loans (the remainder of which were sold in the second quarter of 2016). The impact of these restructurings on our overall business is discussed further throughout this MD&A. In addition, during the third quarter of 2016, we completed the sale of the majority of our commercial mezzanine loan portfolio and currently anticipate completing the sale of the majority of the remaining loans in the fourth quarter of 2016.

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

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

### Consolidated Securitization Entities

We sponsor our Sequoia securitization program, which we use for the securitization of residential mortgage loans. We are required under Generally Accepted Accounting Principles in the United States (“GAAP”) to consolidate the assets and liabilities of certain Sequoia securitization entities we have sponsored for financial reporting purposes. However, each of these entities is independent of Redwood and of each other, and the assets and liabilities of these entities are not owned by us or legal obligations of ours, respectively, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities and, to the extent we hold securities issued by, or other investments in, these entities, we are exposed to the performance of these entities and the assets they hold. We refer to certain of these securitization entities as “consolidated Sequoia entities,” and where applicable, in analyzing our results of operations, we distinguish results from current operations “at Redwood” and from consolidated Sequoia entities.

Additionally, during the fourth quarter of 2012, we engaged in a transaction in which we securitized a pool of commercial loans (the “Commercial Securitization”) primarily for the purpose of obtaining permanent non-recourse financing on a portion of the commercial loans we hold in our investment portfolio at the REIT. During the second quarter of 2016, the debt of the Commercial Securitization was repaid and the majority of the assets held in this entity were sold. We also consolidated the assets and liabilities of an entity formed in connection with a resecuritization transaction we engaged in (“Residential Resecuritization”) from its creation in 2011 through the fourth quarter of 2015, when the debt of the entity was repaid, the assets of the entity were distributed to us, and the entity was dissolved. In analyzing our results of operations, the Commercial Securitization and Residential Resecuritization are included in our

results at Redwood as we view these transactions as a form of financing.

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### Cautionary Statement

This Quarterly Report on Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as “anticipate,” “estimate,” “will,” “should,” “expect,” “believe,” “intend,” “seek,” “plan” and similar expressions or their forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 and this Quarterly Report on Form 10-Q, in each case under the caption “Risk Factors.” Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) statements we make regarding Redwood’s business strategy and strategic focus, including statements relating to our overall market position, strategy and long-term prospects, and private label securitization as a form of mortgage financing, including our expectation about investing in Portfolio Risk Transfer (“PRT”) transactions in the future; (ii) statements related to our outlook and expectations for 2016, including, among other things, any statements relating to future portfolio net interest income, MSR income, residential mortgage banking income (including jumbo loan sales margins), gain on sale income, operating expenses, and tax provision/benefit; (iii) statements related to our commercial loan investments, including our expectation that we will settle the sale of \$27 million of commercial mezzanine loans during the fourth quarter of 2016 and expectations of gain-on-sale income from this sale; (iv) statements related to our residential mortgage banking activities, including new initiatives and our expectations relating to our Choice program continuing to gain momentum in the future; (v) statements regarding our residential investment portfolio, including new investment opportunities and the potential for future capital deployment through credit risk transfer and portfolio risk transfer transactions, statements regarding any future stock repurchase activity, and statements regarding our normalized expectations for MSR income; (vi) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase or plan to purchase, including the amount of such loans that we identified for purchase during the third quarter of 2016 and at September 30, 2016; (vii) statements relating to our estimate of our available capital (including that we estimate our capital available for investments at September 30, 2016 to be approximately \$300 million, and our expectation that this amount will increase by up to an additional \$30 million upon the sale of our commercial mezzanine loans); (viii) statements we make regarding our dividend policy, including our intention to pay a regular dividend of \$0.28 per share per quarter in 2016; and (ix) statements regarding our expectations and estimates relating to the characterization for income tax purposes of our dividend distributions, our expectations and estimates relating to tax accounting, tax liabilities and tax savings, and GAAP tax provisions, our estimates of REIT taxable income and TRS taxable income, and our anticipation of additional credit losses for tax purposes in future periods (and, in particular, our statement that, for tax purposes, we expect an additional \$22 million of tax credit losses on residential securities we currently own to be realized over an estimated three- to five-year period).

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

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

## OVERVIEW

### Business Update

Throughout its history, Redwood has focused on generating long-term value for shareholders through investments in residential mortgage credit risk and through residential loan conduit activities. We have accepted that the residential mortgage market is cyclical and the opportunities are dynamic. Thus, success at times requires patience, while at other times it requires aggressive action.

In today's market, traditional means for investing in mortgage credit have given way to new credit risk-sharing opportunities, largely through transactions with large commercial banks and government-sponsored enterprises ("GSEs"). Execution on these new opportunities requires capital markets and credit expertise, strong relationships, and efficient access to mortgage loans. We see this as a great opportunity to showcase Redwood's nimble and thought-driven business model.

In this update, we review our quarterly results, discuss our capital position, investment opportunities, and operating progress - including the completion of our third Sequoia securitization of 2016 and commercial mezzanine loan sales.

### Third Quarter Results and Capital Position

Our GAAP earnings were \$0.58 per share for the third quarter of 2016, as compared with \$0.48 per share for the second quarter of 2016. Our third quarter earnings benefited from positive mark-to-market adjustments on our fair value securities and higher margins from our jumbo mortgage banking operations compared with the second quarter of 2016. These increases were partially offset by lower commercial loan income, which was elevated in the second quarter of 2016 due to higher loan prepayment interest and the release of loan loss reserves.

We deployed \$76 million of capital during the third quarter toward new investments, bringing our total capital deployed year-to-date in 2016 to just approximately \$300 million. At September 30, 2016, we estimate that our capital available for investments was approximately \$300 million. We expect this amount to increase by up to an additional \$30 million upon the sale of our remaining commercial mezzanine loans.

### Investment Portfolio Initiatives

We remain focused on new and innovative ways to take credit risk on residential loans through portfolio-based initiatives, which will enable us to deploy significant amounts of capital without the infrastructure required to aggregate loans individually. So far in 2016, we've invested in two "Portfolio Risk Transfer" transactions, which facilitate the transfer of credit risk on both jumbo and conforming loans from large commercial banks to private-sector investors like Redwood through traditional REMIC structures, and expect to invest in additional transactions in the coming months. In addition, we've had discussions with some of our larger volume jumbo loan sellers and with other banks to explore ways to complete these types of transactions as an alternative to selling whole loans. We also continue to work directly with the GSEs on other credit-risk sharing initiatives that may result in meaningful new opportunities for Redwood.

### Residential Mortgage Banking

Our residential mortgage banking business had a positive third quarter and is off to a good start in the fourth quarter of 2016, as we closed our third jumbo securitization for 2016 in late October at tighter spreads than our previous transaction in July. Gain-on-sale margins for securitization since the end of the third quarter of 2016 have been slightly better than our more recent whole-loan sale executions, and should benefit our fourth quarter mortgage banking results. Our expanded-prime loan program, Redwood Choice, continues to be rolled out and used by our loan seller network. We expect to continue to gain momentum with the Choice program as we refine its features and pricing.



## Outlook

The third quarter of 2016 was the first in a long period of time during which we experienced consistently low volatility in benchmark interest rates, helping to push credit spreads tighter and valuations higher across many asset classes. Additionally, our mortgage credit performance remained strong. As value investors, we took advantage of this unusually strong pricing and sold certain lower-yielding and non-core investments during the third quarter, in advance of any refinance concerns or other potential credit events. In our view, we maximized the return on these investments for shareholders. And while we remain in a challenging environment to reinvest our capital, with less liquidity available in the financial system to keep volatility low, spread widening may only be a presidential election, Federal Reserve Board meeting, or bad macro-headline away. This makes it, in our view, a good time to be holding capital available for investment. As we head towards the end of the year, we remain extremely focused on our long-term investment initiatives - including with banks and the GSEs, the securitization market, and other vehicles we may use to finance our expanded-prime Choice loans.

## Financial and Operational Overview - Third Quarter of 2016

### Highlights

Our earnings were \$0.58 per share for the third quarter of 2016, as compared with \$0.48 per share for the second quarter of 2016. Third quarter results improved primarily as a result of positive mark-to-market changes driven by tightening spreads on our fair value securities, and above-average margins from our jumbo mortgage banking operations.

Our book value was \$14.74 per share at September 30, 2016, as compared with \$14.20 per share at June 30, 2016.

The increase was driven by our third quarter earnings exceeding our dividend payment, tightening spreads on our available-for-sale securities, and an increase in value of interest rate derivatives hedging our long-term debt.

We deployed \$76 million of capital in the third quarter of 2016 toward new investments, including \$47 million in residential CRT and other subordinate securities, \$25 million in Agency commercial multi-family securities and other CMBS, and \$3 million in MSRs. Additionally, we repurchased \$3 million of common shares during the third quarter at an average price of \$13.45 per share.

We received \$208 million of net cash proceeds from the sale of the majority of our commercial mezzanine loan portfolio and generated realized gains of \$5 million. We currently expect to sell the majority of our remaining commercial mezzanine loans in the fourth quarter.

We sold \$28 million of securities from our investment portfolio during the third quarter of 2016, which generated realized gains of \$2 million and freed up \$5 million of capital for reinvestment after the repayment of associated debt.

We purchased \$1.25 billion of residential jumbo loans during the third quarter of 2016, consistent with the second quarter of 2016. At September 30, 2016, our pipeline of jumbo residential loans identified for purchase was \$1.11 billion.

Residential loan sales totaled \$774 million during the third quarter of 2016 and included \$416 million of whole loan sales to third parties and \$358 million of loans that were securitized.

## Key Earnings Metrics

The following table presents key earnings metrics for the three and nine months ended September 30, 2016.

Table 1 – Key Earnings Metrics

|   | Three<br>Months<br>Ended<br>September<br>30, 2016 | Nine<br>Months<br>Ended<br>September<br>30, 2016 |
|---|---|--|
| (In Thousands, except Share data)         |   |  |
| Net income                                | \$52,553  | \$105,897  |
| Net income per diluted common share       | \$0.58  | \$1.23   |
| REIT Taxable Income per Share             | \$0.34  | \$0.93   |
| Dividends per Share                       | \$0.28  | \$0.84   |
| Annualized GAAP Return on Equity Earnings | 19 %  | 13 %   |

A detailed discussion on our third quarter of 2016 net income is included in the Results of Operations section of this MD&A that follows.

## Book Value per Share

At September 30, 2016, our book value was \$1.13 billion, or \$14.74 per share, an increase from \$14.20 per share at June 30, 2016. The following table sets forth the changes in our book value per share for the three and nine months ended September 30, 2016.

Table 2 – Changes in Book Value per Share

|  | Three Months<br>Ended<br>September 30,<br>2016 | Nine Months<br>Ended<br>September 30,<br>2016 |
|--|--|---|
| (In Dollars, per share basis)                                      |  |   |
| Beginning book value per share                                     | \$ 14.20                                       | \$ 14.67                                      |
| Net income   | 0.58   | 1.23  |
| Changes in unrealized gains on securities, net from:               |  |   |
| Realized gains recognized in net income                            | (0.01 )  | (0.23 )                                       |
| Amortization income recognized in net income                       | (0.06 )  | (0.22 )                                       |
| Mark-to-market adjustments, net                                    | 0.20   | 0.33  |
| Total change in unrealized gains on securities, net                | 0.13   | (0.12 )                                       |
| Dividends  | (0.28 )  | (0.84 )                                       |
| Share repurchases  | —  | 0.04  |
| Equity award distributions   | —  | (0.14 )                                       |
| Changes in unrealized losses on derivatives hedging long-term debt | 0.01   | (0.26 )                                       |
| Non-cash equity award compensation                                 | 0.02   | 0.12  |
| Other, net   | 0.08   | 0.04  |
| Ending Book Value per Share  | \$ 14.74                                       | \$ 14.74                                      |

Our book value per share increased \$0.54 per share to \$14.74 per share during the third quarter of 2016. The increase was primarily driven by our third quarter earnings exceeding our dividend payment and tightening spreads on our available-for-sale securities.

Unrealized gains on our available-for-sale securities increased \$0.13 per share during the third quarter of 2016. The increase was primarily a result of \$0.20 per share increase in the fair value of our available-for-sale securities in the third quarter of 2016. The increase was partially offset by \$0.01 per share of previously unrealized net gains that were realized as income from the sale of securities during the third quarter of 2016, and \$0.06 per share as a result of discount amortization income recognized in earnings during the third quarter of 2016 from the appreciation in amortized cost basis of our available-for-sale securities.

For the third quarter of 2016, our reported earnings were \$53 million, or \$0.58 per diluted common share, based on diluted average shares of 98 million. Under GAAP EPS provisions, this share count assumes all of our convertible and exchangeable debt was converted to equity for the third quarter of 2016. Our book value per share for the third quarter of 2016 was based on actual shares outstanding of 77 million at the end of third quarter. The difference between shares used to calculate earnings per diluted common share and book value per share resulted in a \$0.08 per share benefit to reported book value per share for the third quarter of 2016. This amount is included in other, net in the Changes in Book Value per Share table above. For more details on how we calculate earnings per diluted common share see Note 16 of our Notes to Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q.

During the first nine months of 2016, lower benchmark interest rates resulted in the \$0.23 per share increase in unrealized losses on derivatives hedging a portion of our long-term debt. The offsetting change in the fair value of this long-term debt is not reflected in book value, as the debt is recorded at its amortized cost and not marked-to-market for financial reporting purposes. At September 30, 2016, the cumulative unrealized loss on these derivatives, which is included in book value per share, was \$0.91 per share.

During the first nine months of 2016, we utilized our stock repurchase authorizations to repurchase approximately 1.9 million shares of common stock at an average price of \$12.91 per share. These share repurchases increased book value by \$0.04 per share for the nine months ended September 30, 2016.

#### Capital and Liquidity

Our total capital was \$1.75 billion at September 30, 2016, and included \$1.13 billion of equity capital and \$0.62 billion of the total \$2.62 billion of long-term debt on our consolidated balance sheet. This portion of long-term debt included \$140 million of trust-preferred securities due in 2037, \$288 million of convertible debt due in 2018, and \$201 million of exchangeable debt due in 2019.

## Capital Allocation Summary

We use a combination of equity and corporate long-term debt (which we collectively refer to as “capital”) to fund our business. We also utilize various forms of collateralized short-term and long-term debt to finance certain investments and to warehouse our inventory of certain residential loans held-for-sale. We do not consider this collateralized debt as "capital" and, therefore, it is presented separately from allocated capital in the table below.

Table 3 – Capital Allocation Summary

At September 30, 2016

| (Dollars in Thousands)           | Fair Value  | Collateralized Debt | Allocated Capital | % of Total Capital | 2016 Year-to-Date Return <sup>(1)</sup> |
|----------------------------------|-------------|---------------------|-------------------|--------------------|---|
| Residential investments          |             |                     |                   |                    |   |
| Residential loans/FHLB Stock     | \$2,326,067 | \$(1,999,999 )      | \$326,068         | 19 %               | 17 %                                    |
| Residential securities           | 864,300     | (279,559 )          | 584,741           | 33 %               | 19 %                                    |
| Mortgage servicing rights        | 106,009     | —                   | 106,009           | 6 %                | 8 %                                     |
| Other assets/(other liabilities) | 173,637     | (50,743 )           | 122,894           | 7 %                | — %                                     |
| Available capital                |             |                     | 337,611           | 19 %               | — %                                     |
| Total residential investments    | \$3,470,013 | \$(2,330,301 )      | 1,477,323         | 84 %               | 11 %                                    |
| Commercial investments           | \$103,507   | \$(830 )            | 102,677           | 6 %                | 20 %                                    |
| Residential mortgage banking     |             |                     | 170,000           | 10 %               | 18 %                                    |
| Total                            |             |                     | \$1,750,000       | 100 %              |   |

Includes net interest income, change in fair value of the investments and their associated hedges that flow through (1) earnings, realized gains, direct operating expenses, and other income. Excludes unrealized gains and losses on our AFS securities portfolio, corporate operating expenses, and taxes.

Of our \$1.75 billion of total capital at September 30, 2016, \$1.58 billion (or 90%) was allocated to our investments with the remaining \$170 million (or 10%) allocated to our residential mortgage-banking activities.

Included in our capital allocation is available capital, which represents a combination of capital available for investment and risk capital held for liquidity management purposes. At September 30, 2016, we estimate that our capital available for investments was approximately \$300 million.

## RESULTS OF OPERATIONS

In the first quarter of 2016, we began to present the changes in fair value of certain investments and their associated derivatives in the new line item "Investment fair value changes, net" on our consolidated statements of income and began to present income from mortgage banking activities in "Mortgage banking activities, net" on our consolidated statements of income. All prior periods presented have been conformed to this new presentation for consistency of comparison. Additional information on these changes is provided in Note 2 of our Notes to Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Within this Results of Operations section, we provide commentary that compares results year-over-year for the third quarter of 2016 and 2015. Most tables include a "change" column that shows the amount by which the results from 2016 are greater or less than the results from the respective period in 2015. Unless otherwise specified, references in this section to increases or decreases during the "three month periods" refer to the change in results for the third quarter of 2016, compared to the third quarter of 2015, and increases or decreases in the "nine month periods" refer to the change in results for the first nine months of 2016, compared to the first nine months of 2015.

The following table presents the components of our net income for the three and nine months ended September 30, 2016 and 2015.

Table 4 – Net Income

| (In Thousands, except per Share Data)     | Three Months<br>Ended September<br>30, |           |          | Nine Months Ended<br>September 30, |           |           |
|---|--|-----------|----------|------------------------------------|-----------|-----------|
|   | 2016                                   | 2015      | Change   | 2016                               | 2015      | Change    |
| Net Interest Income                       | \$39,309                               | \$39,609  | \$(300 ) | \$122,030                          | \$119,759 | \$2,271   |
| Reversal of provision for loan losses     | 859                                    | 60        | 799      | 7,102                              | 115       | 6,987     |
| Net Interest Income After Provision       | 40,168                                 | 39,669    | 499      | 129,132                            | 119,874   | 9,258     |
| Non-interest Income                       |  |           |          |                                    |           |           |
| Mortgage banking activities, net          | 9,766                                  | 1,333     | 8,433    | 24,712                             | 10,706    | 14,006    |
| MSR income (loss), net                    | 3,770                                  | 3,549     | 221      | 12,834                             | (6,545 )  | 19,379    |
| Investment fair value changes, net        | 11,918                                 | (14,169 ) | 26,087   | (18,686 )                          | (17,105 ) | (1,581 )  |
| Other income                              | 1,643                                  | 327       | 1,316    | 4,157                              | 2,435     | 1,722     |
| Realized gains, net                       | 6,615                                  | 5,548     | 1,067    | 26,037                             | 16,170    | 9,867     |
| Total non-interest income, net            | 33,712                                 | (3,412 )  | 37,124   | 49,054                             | 5,661     | 43,393    |
| Operating expenses                        | (20,355 )                              | (24,497 ) | 4,142    | (70,962 )                          | (74,778 ) | 3,816     |
| Net income before income taxes            | 53,525                                 | 11,760    | 41,765   | 107,224                            | 50,757    | 56,467    |
| (Provision for) benefit from income taxes | (972 )                                 | 7,404     | (8,376 ) | (1,327 )                           | 10,272    | (11,599 ) |
| Net Income                                | \$52,553                               | \$19,164  | \$33,389 | \$105,897                          | \$61,029  | \$44,868  |
| Diluted earnings per common share         | \$0.58                                 | \$0.22    | \$0.36   | \$1.23                             | \$0.69    | \$0.54    |

## Net Interest Income

The decrease in net interest income in the three month periods was primarily due to lower average balances of securities as well as conforming and commercial loans during 2016. The decrease in loan balances resulted from the wind-down of conforming and commercial loan purchases and sales during the first quarter of 2016. The decrease in the balances of securities resulted from net dispositions, as we reallocated capital to investments in residential jumbo loans. This decrease in net interest income was offset from a higher average balance of residential loans held-for-investment by our FHLB-member subsidiary and financed with FHLBC advances.

The increase in net interest income in the nine month period was primarily due to higher average balances of residential loans held-for-investment by our FHLB-member subsidiary and financed with the FHLBC, as well as \$5 million of prepayment penalty interest received from four commercial loans during the second quarter of 2016. These increases were partially offset by a decline in average balances of our available-for-sale securities and conforming and commercial loans, as discussed above. Additional detail on changes in net interest income is provided in the "Net Interest Income" section that follows.



#### Reversal of Provision for Loan Losses

The increase in the reversal of provision for loan losses in the three month periods was primarily due to the reversal of provision resulting from loan repayments during the third quarter of 2016. The increase in the reversal of provision for loan losses in the nine month periods was primarily due to the reclassification of most of our commercial mezzanine loans to held-for-sale classification at the lower of cost or market in the second quarter of 2016, whereby we determined an allowance was no longer required for the loans. Additional detail regarding sales of our commercial mezzanine loans is provided in the "Results of Operations by Segment" section that follows.

#### Mortgage Banking Activities, Net

Income from mortgage banking activities, net includes results from our residential jumbo mortgage banking operations and, prior to the second quarter of 2016, results from our residential conforming and commercial mortgage banking operations. The increase during the three and nine month periods was predominantly due to higher gross margins from our jumbo residential mortgage banking activities on similar volume, which resulted in \$9 million and \$19 million increases, respectively. These increases were partially offset by \$1 million and \$5 million declines in income from commercial mortgage banking activities for the three and nine month periods, respectively, as we wound down those operations during the first quarter of 2016.

A more detailed analysis of the changes in this line item by business segment is included in the "Results of Operations by Segment" section that follows.

#### MSR Income (Loss), Net

MSR income (loss), net is comprised of the net fee income we earn from our MSR investments, changes in their market value and, beginning in the second quarter of 2015, changes in the market value of derivatives used to hedge our exposure to interest rate risk from our MSR investments.

MSR income during the three month periods remained relatively stable. Given our current balance of MSR investments, MSR income during the third quarter of 2016 was within our normalized expectation of \$3 million to \$4 million per quarter. MSR income for the first nine months of 2015 does not include the effect of hedges during the first quarter of 2015, as we hedged these investments on an enterprise-wide basis prior to the second quarter of 2015 and did not have specific derivatives to allocate to the MSRs during that period. The loss during the first nine months of 2015 primarily reflects the negative change in market value of our MSRs during the first quarter of 2015, resulting from the decrease in market interest rates during that period. The offsetting increase in the value of assets and derivatives that effectively served as hedges to the MSRs during the first quarter of 2015 is presented in Investment fair value changes, net.

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

#### Investment Fair Value Changes, Net

Investment fair value changes, net, is primarily comprised of the change in fair values of our residential loans held-for-investment and financed with FHLB borrowings, our investment securities classified as trading, and interest rate hedges associated with each of these investments.

During the three months ended September 30, 2016, the positive investment fair value changes primarily resulted from increases in the fair value of our trading securities and their associated hedges, which together resulted in a \$9 million increase. This increase was primarily the result of tightening spreads on these securities. During the nine months ended September 30, 2016, the negative investment fair value changes primarily resulted from decreases in the fair value of our loans held for investment and their associated hedges. These decreases were primarily the result of hedging costs due to interest rate volatility during the first half of the year, as well as decreases in fair value resulting from the write-off of premium from loan repayments.

During the three and nine months ended September 30, 2015, the negative investment fair value changes primarily resulted from decreases in the fair value of our trading securities as well as hedging costs for our securities and held-for-investment loans. In addition, during the first quarter of 2015, this line item also included the change in fair value of certain assets and derivatives we used to hedge our MSRs, as we did not begin to specifically identify derivatives for hedging MSRs until the second quarter of 2015.

Additional detail on our investment fair value changes is included in the Residential Investments portion of the "Results of Operations by Segment" section that follows.





#### Realized Gains, Net

During the third quarter of 2016, we realized gains of \$7 million, which included \$2 million primarily from the sale of \$26 million of AFS securities and \$5 million from the sale of \$208 million of commercial mezzanine loans. During the third quarter of 2015, we realized gains of \$6 million, primarily from the sale of \$35 million of AFS securities. For the nine months ended September 30, 2016, we realized gains of \$26 million, which included \$21 million primarily from the sale of \$241 million of AFS securities and \$5 million from the sale of \$208 million of commercial mezzanine loans. For the nine months ended September 30, 2015, we realized gains of \$16 million, primarily from the sale of \$237 million of AFS securities.

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

#### Operating Expenses

The decrease in operating expenses during the three and nine month periods was primarily due to the restructuring of our residential conforming and commercial mortgage banking operations during the first quarter of 2016, which resulted in a lower run-rate of expenses. Operating expenses for the nine months ended September 30, 2016 include \$11 million of restructuring charges recorded during the first quarter of 2016. Excluding these restructuring related expenses, operating expenses were \$60 million during the nine months ended September 30, 2016.

See Note 11 of our Notes to Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for additional detail of these restructuring charges.

#### Other Income

Other income in both the three and nine month periods was primarily comprised of income from risk sharing arrangements with Fannie Mae and Freddie Mac.

#### (Provision for) Benefit From Income Taxes

Our income taxes result almost entirely from activity at our taxable REIT subsidiaries, which primarily includes our mortgage banking activities and MSR investments, as well as certain investment hedging activities. During the first nine months of 2016, we recorded a tax provision of \$1 million, primarily related to ordinary GAAP income earned at the TRS during that period.

The benefit from income taxes in the nine month period of 2015 resulted from GAAP losses generated at our TRS during that period that were primarily due to lower mortgage banking income and negative market valuation adjustments on derivatives. For additional detail on income taxes, see the “Taxable Income” section that follows.

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Net Interest Income

The following tables present the components of net interest income for the three and nine months ended September 30, 2016 and 2015.

Table 5 – Net Interest Income

| (Dollars in Thousands)                            | Three Months Ended September 30,    |                  |                |                                     |                  |                |
|---|-------------------------------------|------------------|----------------|-------------------------------------|------------------|----------------|
|   | 2016                                |                  |                | 2015                                |                  |                |
|   | Interest                            | Average          | Yield          | Interest                            | Average          | Yield          |
|   | Income/<br>(Expense) <sup>(1)</sup> | Balance          |                | Income/<br>(Expense) <sup>(1)</sup> | Balance          |                |
| <b>Interest Income</b>                            |                                     |                  |                |                                     |                  |                |
| Residential loans, held-for-sale                  | \$8,835                             | \$995,136        | 3.6 %          | \$12,116                            | \$1,295,018      | 3.7 %          |
| Residential loans - HFI at Redwood <sup>(2)</sup> | 21,923                              | 2,260,895        | 3.9 %          | 11,258                              | 1,167,534        | 3.9 %          |
| Residential loans - HFI at Sequoia <sup>(2)</sup> | 4,837                               | 849,234          | 2.3 %          | 6,098                               | 1,191,702        | 2.0 %          |
| Commercial loans                                  | 6,453                               | 261,194          | 9.9 %          | 11,191                              | 527,359          | 8.5 %          |
| Trading securities                                | 5,831                               | 301,110          | 7.7 %          | 3,476                               | 115,712          | 12.0 %         |
| Available-for-sale securities                     | 12,769                              | 488,842          | 10.4 %         | 19,273                              | 838,305          | 9.2 %          |
| Other interest income                             | 258                                 | 226,730          | 0.5 %          | 72                                  | 204,746          | 0.1 %          |
| <b>Total interest income</b>                      | <b>60,906</b>                       | <b>5,383,141</b> | <b>4.5 %</b>   | <b>63,484</b>                       | <b>5,340,376</b> | <b>4.8 %</b>   |
| <b>Interest Expense</b>                           |                                     |                  |                |                                     |                  |                |
| Short-term debt                                   | (5,405 )                            | 1,071,757        | (2.0 )%        | (7,627 )                            | 1,693,263        | (1.8 )%        |
| ABS issued - Redwood                              | 81                                  | —                | — %            | (1,348 )                            | 76,788           | (7.0 )%        |
| ABS issued - Sequoia <sup>(2)</sup>               | (3,274 )                            | 828,411          | (1.6 )%        | (3,842 )                            | 1,128,334        | (1.4 )%        |
| Long-term debt - FHLBC                            | (2,892 )                            | 1,999,999        | (0.6 )%        | (747 )                              | 911,014          | (0.3 )%        |
| Long-term debt - other                            | (10,107 )                           | 674,131          | (6.0 )%        | (10,311 )                           | 685,617          | (6.0 )%        |
| <b>Total interest expense</b>                     | <b>(21,597 )</b>                    | <b>4,574,298</b> | <b>(1.9 )%</b> | <b>(23,875 )</b>                    | <b>4,495,016</b> | <b>(2.1 )%</b> |
| <b>Net Interest Income</b>                        | <b>\$39,309</b>                     |                  |                | <b>\$39,609</b>                     |                  |                |
| <b>Nine Months Ended September 30,</b>            |                                     |                  |                |                                     |                  |                |
| (Dollars in Thousands)                            | 2016                                |                  |                | 2015                                |                  |                |
|   | Interest                            | Average          | Yield          | Interest                            | Average          | Yield          |
|   | Income/<br>(Expense) <sup>(1)</sup> | Balance          |                | Income/<br>(Expense) <sup>(1)</sup> | Balance          |                |
| <b>Interest Income</b>                            |                                     |                  |                |                                     |                  |                |
| Residential loans, held-for-sale                  | \$24,062                            | \$886,777        | 3.6 %          | \$33,561                            | \$1,222,550      | 3.7 %          |
| Residential loans - HFI at Redwood <sup>(2)</sup> | 63,562                              | 2,178,997        | 3.9 %          | 27,150                              | 952,802          | 3.8 %          |
| Residential loans - HFI at Sequoia <sup>(2)</sup> | 14,525                              | 907,617          | 2.1 %          | 19,578                              | 1,270,786        | 2.1 %          |
| Commercial loans                                  | 28,834                              | 338,390          | 11.4 %         | 34,784                              | 526,787          | 8.8 %          |
| Trading securities                                | 15,639                              | 271,758          | 7.7 %          | 13,346                              | 114,524          | 15.5 %         |
| Available-for-sale securities                     | 42,473                              | 553,278          | 10.2 %         | 62,017                              | 932,837          | 8.9 %          |
| Other interest income                             | 926                                 | 318,138          | 0.4 %          | 167                                 | 219,792          | 0.1 %          |
| <b>Total interest income</b>                      | <b>190,021</b>                      | <b>5,454,955</b> | <b>4.6 %</b>   | <b>190,603</b>                      | <b>5,240,078</b> | <b>4.8 %</b>   |
| <b>Interest Expense</b>                           |                                     |                  |                |                                     |                  |                |
| Short-term debt                                   | (17,439 )                           | 1,150,206        | (2.0 )%        | (21,378 )                           | 1,555,180        | (1.8 )%        |
| ABS issued - Redwood                              | (1,615 )                            | 28,264           | (7.6 )%        | (4,665 )                            | 97,946           | (6.4 )%        |
| ABS issued - Sequoia <sup>(2)</sup>               | (9,842 )                            | 885,752          | (1.5 )%        | (12,372 )                           | 1,206,032        | (1.4 )%        |
| Long-term debt - FHLBC                            | (8,634 )                            | 1,974,582        | (0.6 )%        | (1,748 )                            | 781,924          | (0.3 )%        |
| Long-term debt - other                            | (30,461 )                           | 680,576          | (6.0 )%        | (30,681 )                           | 686,230          | (6.0 )%        |
| <b>Total interest expense</b>                     | <b>(67,991 )</b>                    | <b>4,719,380</b> | <b>(1.9 )%</b> | <b>(70,844 )</b>                    | <b>4,327,312</b> | <b>(2.2 )%</b> |
| <b>Net Interest Income</b>                        | <b>\$122,030</b>                    |                  |                | <b>\$119,759</b>                    |                  |                |



## Footnotes to Table 5

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

Interest income from residential loans held-for-investment ("HFI") at Redwood exclude loans HFI at consolidated (2) Sequoia entities. Interest income from residential loans - HFI at Sequoia and the interest expense from ABS issued - Sequoia represent activity from our consolidated Sequoia entities.

The following table presents net interest income by segment for the three and nine months ended September 30, 2016 and 2015.

Table 6– Net Interest Income by Segment

| (In Thousands)                 | Three Months Ended September 30, |          |          | Nine Months Ended September 30, |           |           |
|--------------------------------|----------------------------------|----------|----------|---------------------------------|-----------|-----------|
|                                | 2016                             | 2015     | Change   | 2016                            | 2015      | Change    |
| Net Interest Income by Segment |                                  |          |          |                                 |           |           |
| Residential Investments        | \$35,510                         | \$31,414 | \$4,096  | \$106,736                       | \$90,198  | \$16,538  |
| Residential Mortgage Banking   | 5,005                            | 7,802    | (2,797 ) | 13,891                          | 26,497    | (12,606 ) |
| Commercial                     | 6,653                            | 7,689    | (1,036 ) | 24,926                          | 24,296    | 630       |
| Corporate/Other                | (7,859 )                         | (7,296 ) | (563 )   | (23,523 )                       | (21,232 ) | (2,291 )  |
| Net Interest Income            | \$39,309                         | \$39,609 | \$(300 ) | \$122,030                       | \$119,759 | \$2,271   |

## Analysis of Changes in Net Interest Income

The \$4 million and \$17 million increases in net interest income from our Residential Investments segment for the three and nine month periods, respectively, were primarily due to increases in interest income resulting from a higher average balance of residential loans held-for-investment by our FHLB-member subsidiary and financed with FHLBC advances during the first nine months of 2016. These increases were partially offset by lower net interest income from investments in securities, primarily resulting from a lower average balance of available-for-sale securities in both the three and nine months ended September 30, 2016 as compared to the same periods in 2015, as we sold securities and reallocated capital from securities investments into loan investments during that time period.

The \$3 million and \$13 million decreases in net interest income from our Residential Mortgage Banking segment for the three and nine month periods, respectively, were primarily due to lower average balances of conforming loans during 2016, resulting from the wind-down of conforming loan purchases and sales during the first quarter of 2016. In addition, certain Sequoia securities that were included in this segment through the first quarter of 2015, and transferred into our Residential Investments segment in the second quarter of 2015, accounted for \$2 million of the decrease during the nine month periods.

The \$1 million decrease in net interest income from our Commercial segment for the three month period was primarily due to lower average balances of commercial mezzanine loans resulting from loan sales and repayments during the past 12 months. The \$1 million increase in net interest income from our Commercial segment for the nine month periods was primarily due to \$5 million of prepayment penalty interest received in the second quarter of 2016, as compared with \$2 million received during the nine month period of 2015. These increases were partially offset by lower average balances of commercial mezzanine loans resulting from loan sales and repayments during the past 12 months.

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

The Corporate/Other line item includes interest expense related to long-term debt not directly allocated to our segments and net interest income from consolidated Sequoia entities. The \$1 million and \$2 million decrease in net interest income from Corporate/Other during the three and nine month periods, respectively, was primarily due to lower net interest income from consolidated Sequoia entities, as loans in these securitizations continue to pay down. Details regarding consolidated Sequoia entities are included in the "Results from Consolidated Sequoia Entities" section that follows.

The following table presents the net interest rate spread between the yield on unsecuritized loans and securities and the debt yield of the short-term debt used in part to finance each investment type at September 30, 2016.

Table 7 – Interest Expense — Specific Borrowing Costs

| September 30, 2016    | Residential<br>Loans<br>Held-for-Sale |   | Residential<br>Securities |   |
|-----------------------|---------------------------------------|---|---------------------------|---|
| Asset yield           | 3.63                                  | % | 4.88                      | % |
| Short-term debt yield | 2.07                                  | % | 1.79                      | % |
| Net Spread            | 1.56                                  | % | 3.09                      | % |

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

#### Results of Operations by Segment

The following is a discussion of the results of operations for our three business segments for the three and nine months ended September 30, 2016 and 2015. For additional information on our segments, refer to Note 22 of our Notes to Consolidated Financial Statements in Part I, Item I of this Quarterly Report on Form 10 Q.

#### Residential Investments Segment

Our Residential Investments segment is primarily comprised of our portfolio of residential mortgage loans held-for-investment and financed through the FHLBC, our residential securities portfolio, and our MSR investment portfolio. For segment reporting purposes, certain of our Sequoia senior trading securities were included in our Residential Mortgage Banking segment and our commercial securities were included in our Commercial segment. As such, they are excluded from any amounts and tables in this section and may not agree with similarly titled amounts and tables in our consolidated financial statements and footnotes.

The following table presents the components of segment contribution for the Residential Investments segment for the three and nine months ended September 30, 2016 and 2015.

Table 8 – Residential Investments Segment Contribution

| (In Thousands)                            | Three Months Ended September 30, |           |          | Nine Months Ended September 30, |           |          |
|---|----------------------------------|-----------|----------|---------------------------------|-----------|----------|
|   | 2016                             | 2015      | Change   | 2016                            | 2015      | Change   |
| Interest income                           | \$39,981                         | \$34,074  | \$5,907  | \$120,812                       | \$98,335  | \$22,477 |
| Interest expense                          | (4,471 )                         | (2,660 )  | (1,811 ) | (14,076 )                       | (8,137 )  | (5,939 ) |
| Net interest income                       | 35,510                           | 31,414    | 4,096    | 106,736                         | 90,198    | 16,538   |
| Non-interest income                       |                                  |           |          |                                 |           |          |
| MSR income (loss), net                    | 3,770                            | 3,549     | 221      | 12,834                          | (6,545 )  | 19,379   |
| Investment fair value changes, net        | 11,973                           | (13,622 ) | 25,595   | (16,913 )                       | (14,745 ) | (2,168 ) |
| Other income                              | 1,643                            | 327       | 1,316    | 4,130                           | 2,435     | 1,695    |
| Realized gains, net                       | 1,991                            | 5,548     | (3,557 ) | 21,312                          | 16,170    | 5,142    |
| Total non-interest income (loss), net     | 19,377                           | (4,198 )  | 23,575   | 21,363                          | (2,685 )  | 24,048   |
| Direct operating expenses                 | (2,498 )                         | (1,311 )  | (1,187 ) | (6,517 )                        | (3,600 )  | (2,917 ) |
| Segment contribution before income taxes  | 52,389                           | 25,905    | 26,484   | 121,582                         | 83,913    | 37,669   |
| (Provision for) benefit from income taxes | (732 )                           | 4,082     | (4,814 ) | (1,087 )                        | 3,824     | (4,911 ) |
| Total Segment Contribution                | \$51,657                         | \$29,987  | \$21,670 | \$120,495                       | \$87,737  | \$32,758 |

The following table presents our primary portfolios of investment assets in our Residential Investments segment at September 30, 2016 and December 31, 2015.

Table 9 – Residential Investments

| (In Thousands)                        | September 30, December 31, |              | Change     |
|---------------------------------------|----------------------------|--------------|------------|
|                                       | 2016                       | 2015         |            |
| Residential loans held-for-investment | \$ 2,282,674               | \$ 1,791,195 | \$491,479  |
| Residential securities                | 864,300                    | 1,028,171    | (163,871 ) |
| Mortgage servicing rights             | 106,009                    | 191,976      | (85,967 )  |
| Total Residential Investments         | \$ 3,252,983               | \$ 3,011,342 | \$241,641  |

## Overview

The increase in our total residential investments in the first nine months of 2016 was primarily attributable to the addition of residential loans held-for-investment and financed through the FHLBC, as our FHLB-member subsidiary fully utilized its borrowing capacity of \$2.00 billion. This increase was partially offset by a decrease in our investments in residential securities and MSRs, resulting from net sales during the first nine months of 2016. We expect net interest income from our investments in residential loans held-for-investment to stabilize over the remainder of 2016, as we have fully utilized our FHLB-member subsidiary's borrowing capacity. For the nine months ended September 30, 2016, our segment contribution from Residential Investments was comprised of \$36 million from residential loans, \$76 million from residential securities, and \$8 million from MSRs.

## Net Interest Income

Net interest income from Residential Investments primarily includes interest income from our residential loans held-for-investment and our residential securities, as well as the associated interest expense from short-term debt, FHLBC borrowings, and ABS issued. The following table presents the components of net interest income for our Residential Investments segment for the three and nine months ended September 30, 2016 and 2015.

Table 10 - Net Interest Income ("NII") from Residential Investments

| (In Thousands)                      | Three Months<br>Ended September<br>30, |          |          | Nine Months<br>Ended September<br>30, |          |           |
|-------------------------------------|--|----------|----------|---------------------------------------|----------|-----------|
|                                     | 2016                                   | 2015     | Change   | 2016                                  | 2015     | Change    |
| Net interest income from HFI loans  | \$19,031                               | \$10,511 | \$8,520  | \$54,920                              | \$25,402 | \$29,518  |
| Net interest income from securities | 16,279                                 | 20,836   | (4,557 ) | 51,013                                | 64,645   | (13,632 ) |
| Other interest income               | 200                                    | 67       | 133      | 803                                   | 151      | 652       |
| NII from Residential Investments    | \$35,510                               | \$31,414 | \$4,096  | \$106,736                             | \$90,198 | \$16,538  |

The increases in net interest income from our Residential Investments segment for the three and nine month periods, respectively, were primarily due to increases in interest income resulting from a higher average balance of residential loans held-for-investment by our FHLB-member subsidiary and financed with FHLBC advances during the first nine months of 2016. These increases were partially offset by lower net interest income from investments in securities, primarily resulting from a lower average balance of available-for-sale securities in both the three and nine months ended September 30, 2016 as compared to the same periods in 2015, as we sold securities and reallocated capital from securities investments into loan investments during that time period.

## Investment fair value changes, net

The following table presents the components of investment fair value changes, net for our Residential Investments segment, which is comprised of market valuation gains and losses from our residential investments and associated hedges, for the three and nine months ended September 30, 2016 and 2015.

Table 11 - Investment Fair Value Changes, Net from Residential Investments

| (In Thousands)                                       | Three Months<br>Ended September<br>30, |            | Nine Months Ended<br>September 30, |            |
|--|--|------------|------------------------------------|------------|
|  | 2016                                   | 2015       | 2016                               | 2015       |
| Investment Fair Value Changes, Net                   |  |            |                                    |            |
| Market valuation changes:                            |  |            |                                    |            |
| Residential loans held-for-investment <sup>(1)</sup> | \$(655 )                               | \$9,077    | \$22,161                           | \$5,170    |
| Trading securities - IOs                             | 1,388                                  | (9,263 )   | (11,525 )                          | (616 )     |
| Trading securities - other                           | 7,172                                  | 479        | 14,169                             | (971 )     |
| Risk sharing investments                             | 15                                     | (1,098 )   | (689 )                             | (1,799 )   |
| Risk management derivatives                          | 4,053                                  | (12,591 )  | (40,724 )                          | (16,303 )  |
| Impairments on AFS securities                        | —                                      | (226 )     | (305 )                             | (226 )     |
| Investment Fair Value Changes, Net                   | \$11,973                               | \$(13,622) | \$(16,913)                         | \$(14,745) |

<sup>(1)</sup> Market valuation changes from residential loans held-for-investment above do not include loans at consolidated Sequoia entities, which are not included in this segment.

Market valuation changes included in Investment fair value changes, net, generally result from changes in the fair value of investments and their associated hedges due to changes in market interest rates, changes in credit spreads, and reductions in the basis of investments. For residential loans recorded at a premium and IO securities, a reduction in basis occurs when associated principal is repaid or written-off, which results in a decrease in fair value from the loss of premium. In addition, valuation changes from risk management derivatives associated with our mezzanine securities portfolio are included in this line item while valuation changes of AFS mezzanine securities are reported through Accumulated other comprehensive income on our consolidated balance sheets. This mismatch creates periodic volatility in this line item as interest rates change each quarter.

Within this segment, our residential loans held-for-investment, trading securities, certain mezzanine securities, MSR investments and risk sharing investments are all subject to market interest rate risk. Historically, we managed our exposure to market interest rate risk for these assets on an enterprise-wide basis and relied on certain assets (i.e., jumbo loans and jumbo loan purchase commitments) to serve as natural hedges to other assets (i.e., IO securities and risk sharing investments) that change in value inversely as interest rates change, and then used derivatives to manage our net exposure.

In the second quarter of 2015, we began to specifically identify derivatives used to hedge our exposure to interest rate risk from our MSR investments and present the changes in the value of those derivatives as a component of MSR income (loss), net, on our consolidated statements of income. Prior to the second quarter of 2015, the changes in values of investments that in part served as hedges to our MSRs were presented in Investment fair value changes, net, on our consolidated statements of income.

The following table presents the components of investment fair value changes in this segment, net for the three and nine months ended September 30, 2016.

Table 12 - Components of Investment Fair Value Changes, Net from Residential Investments

| (In Thousands)  | Three<br>Months<br>Ended<br>September<br>30, 2016 | Nine<br>Months<br>Ended<br>September<br>30, 2016 |
|---|---|--|
| Market valuation changes on:  |   |  |
| Residential loans held-for-investment   |   |  |
| Change in fair value from the reduction of principal <sup>(1)</sup>               | \$ (4,724 )                                       | \$ (9,855 )                                      |
| Change in fair value from changes in interest rates and spreads <sup>(2)</sup>    | 4,069   | 32,016   |
| Total change in fair value of residential loans held-for-investment               | (655 )  | 22,161   |
| Residential securities  |   |  |
| Change in fair value from the reduction of principal <sup>(1)</sup>               | (1,383 )  | (3,636 )   |
| Change in fair value from changes in interest rates and spreads <sup>(2)</sup>    | 9,958   | 5,286  |
| Total change in fair value of residential securities                              | 8,575   | 1,650  |
| Risk management derivatives   |   |  |
| Interest component of derivative expense  | (1,885 )  | (6,756 )   |
| Change in fair value of derivatives from changes in interest rates <sup>(3)</sup> | 5,938   | (33,968 )  |
| Total change in fair value of risk management derivatives                         | 4,053   | (40,724 )  |
| Total Residential Investments Fair Value Changes, Net <sup>(4)</sup>              | \$ 11,973   | \$ (16,913 )                                     |

Reflects the change in fair value due to principal changes, which is calculated as the change in principal on a given investment during the period, multiplied by the prior quarter ending price or acquisition price for that investment in percentage terms.

<sup>(2)</sup> Reflects changes in prepayment assumptions and credit spreads on our residential loans, residential trading securities and conforming risk-sharing investments primarily due to changes in benchmark interest rates.

<sup>(3)</sup>



Reflects the change in fair value of our risk management derivatives that are associated with changes in benchmark interest rates during the period.

- (4) Total investment fair value changes, net, on our consolidated financial statements also includes a \$0.3 million loss and a \$2 million loss for the three and nine months ended September 30, 2016, respectively, related to changes in fair value of our investments in legacy consolidated Sequoia transactions, which is included in Corporate/Other for segment reporting.

For the three and nine months ended September 30, 2016, investment fair value changes were positive \$3 million and negative \$19 million, respectively, for residential loans held-for-investment and their associated derivatives, and positive \$9 million and positive \$2 million, respectively, for residential securities and their associated derivatives. The increase in fair values from loans and their associated derivatives during the third quarter of 2016 primarily resulted from tightening spreads during that period. These increases were partially offset by reductions in the fair value of loans from the loss of premium from principal repayments. The decrease in the fair values from loans and their associated derivatives during the first nine months of 2016 primarily resulted from the loss of premium from principal repayments during that period as well as increased hedging costs resulting from interest rate volatility during the first half of the year.

The increase in fair values from securities and their associated derivatives during the three and nine month periods ending September 30, 2016, primarily resulted from tightening spreads during those periods. These were partially offset by reductions in fair value resulting from reductions in the basis of IO securities from associated principal repayments as well as from hedging costs.

#### MSR Income (Loss), net

The following table presents the components of MSR income (loss), net for the three and nine months ended September 30, 2016 and 2015.

Table 13 – MSR Income (Loss), net

| (In Thousands)  | Three Months<br>Ended<br>September 30, |          | Nine Months<br>Ended September<br>30, |            |
|---|--|----------|---------------------------------------|------------|
|   | 2016                                   | 2015     | 2016                                  | 2015       |
| Net servicing fee income  | \$8,726                                | \$8,715  | \$27,241                              | \$24,495   |
| Changes in fair value of MSR from the receipt of expected cash flows                  | (5,705 )                               | (4,710 ) | (17,766 )                             | (13,684 )  |
| MSR provision for repurchases   | —                                      | (221 )   | 208                                   | (439 )     |
| MSR income before the effect of changes in interest rates and other assumptions       | 3,021                                  | 3,784    | 9,683                                 | 10,372     |
| Changes in fair value of MSR from interest rates and other assumptions <sup>(1)</sup> | 7,085                                  | (23,786) | (52,723 )                             | (18,653 )  |
| Changes in fair value of associated derivatives                                       | (6,336 )                               | 23,551   | 55,874                                | 1,736      |
| Total net effect of changes in assumptions and rates                                  | 749                                    | (235 )   | 3,151                                 | (16,917 )  |
| MSR Income (Loss), Net  | \$3,770                                | \$3,549  | \$12,834                              | \$(6,545 ) |

(1) Primarily reflects changes in prepayment assumptions on our MSR's due to changes in benchmark interest rates.

MSR income before the effect of changes in interest rates and other assumptions remained stable during the three and nine month periods, given relatively comparable underlying notional loan balances in each period. MSR Income related to the net effect of changes in assumptions and rates was positive for both the three and nine months ended September 30, 2016, reflecting a benefit from low interest rate volatility during the third quarter of 2016.

MSR income for the first nine months of 2015 does not include the effect of hedges during the first quarter of 2015, as we hedged these investments on an enterprise-wide basis prior to the second quarter of 2015 and did not have specific derivatives to allocate to the MSR's during that period. The loss during the first nine months of 2015 primarily reflects the negative change in market value of our MSR's during the first quarter of 2015, resulting from the decrease in market interest rates during that period. The offsetting increase in the value of assets and derivatives that effectively served as hedges to the MSR's during the first quarter of 2015 is presented in Investment fair value changes, net.

**Realized Gains, net**

During the third quarter of 2016, we realized gains of \$2 million, primarily from the sale of \$26 million of AFS securities. During the third quarter of 2015, we realized gains of \$6 million primarily from the sale of \$35 million of AFS securities. During the nine months of 2016, we realized gains of \$21 million, primarily from the sale of \$241 million of AFS securities. During the nine months of 2015, we realized gains of \$16 million primarily from the sale of \$237 million of AFS securities.

**Direct Operating Expenses and Provision for Income Taxes**

The increase in operating expenses at our Residential Investments segment in 2016 was primarily attributable to higher personnel costs associated with the management of our investments. For the three and nine months ended September 30, 2016, the provision for income taxes at our Residential Investments segment resulted from ordinary income earned at our TRS during those periods, primarily from MSR income and interest income on certain securities we hold at our TRS.

**Residential Loans Held-for-Investment Portfolio**

The following table provides the activity of residential loans held-for-investment at Redwood during the three and nine months ended September 30, 2016 and 2015.

Table 14 – Residential Loans Held-for Investment at Redwood - Activity

| (In Thousands)                    | Three Months Ended |             | Nine Months Ended |             |
|-----------------------------------|--------------------|-------------|-------------------|-------------|
|                                   | September 30,      |             | September 30,     |             |
|                                   | 2016               | 2015        | 2016              | 2015        |
| Fair value at beginning of period | \$2,277,561        | \$1,157,285 | \$1,791,195       | \$581,668   |
| Transfers between portfolios      | 151,919            | 233,429     | 821,273           | 897,050     |
| Principal repayments              | (146,151 )         | (39,514 )   | (351,955 )        | (123,611 )  |
| Changes in fair value, net        | (655 )             | 9,077       | 22,161            | 5,170       |
| Fair Value at End of Period       | \$2,282,674        | \$1,360,277 | \$2,282,674       | \$1,360,277 |

During the three and nine months ended September 30, 2016, we had net transfers of \$152 million and \$821 million, respectively, of residential loans from our Residential Mortgage Banking segment to our Residential Investments segment. At September 30, 2016, \$2.28 billion of loans were held by our FHLB-member subsidiary and were financed with \$2.00 billion of borrowings from the FHLBC. In connection with these borrowings, our FHLB-member subsidiary is required to hold \$43 million of FHLB stock.

At September 30, 2016, the weighted average maturity of these FHLB borrowings was approximately nine years and they had a weighted average cost of 0.57% per annum. This interest cost resets every 13 weeks and we seek to fix the interest cost of these FHLB borrowings over their weighted average maturity by using a combination of swaps, TBAs and other derivatives.

Under a final rule published by the Federal Housing Finance Agency in January 2016, our FHLB-member subsidiary will remain an FHLB member through the five-year transition period for captive insurance companies. Our FHLB-member subsidiary's existing \$2.00 billion of FHLB debt, which matures beyond this transition period, is permitted to remain outstanding until the stated maturity. As residential loans pledged as collateral for this debt pay down, we are permitted to pledge additional loans or other eligible assets to collateralize this debt; however, we do not expect to be able to increase our subsidiary's FHLB debt above the existing \$2.00 billion.

The following table presents the unpaid principal balances for residential real estate loans held-for-investment at fair value by product type at September 30, 2016.

Table 15 – Characteristics of Residential Real Estate Loans Held-for Investment at Fair Value  
September 30, 2016

| (Dollars in Thousands)      | Principal<br>Balance | Weighted<br>Average<br>Coupon |
|-----------------------------|----------------------|-------------------------------|
| Fixed - 30 year             | \$2,142,382          | 4.14 %                        |
| Fixed - 15, 20, & 25 year   | 59,082               | 3.63 %                        |
| Hybrid                      | 10,296               | 3.83 %                        |
| Total Outstanding Principal | \$2,211,760          |                               |

The outstanding loans held-for-investment at Redwood at September 30, 2016 were prime-quality, first lien loans, of which 93% were originated between 2013 and 2016 and 7% were originated in 2012 and prior years. The weighted average FICO score of borrowers backing these loans was 773 (at origination) and the weighted average loan-to-value ("LTV") ratio was 66% (at origination). At September 30, 2016, none of these loans were more than 90 days delinquent or in foreclosure.

#### Residential Securities Portfolio

The following table sets forth real estate securities activity by collateral type in our Residential Investments segment for the three and nine months ended September 30, 2016.

Table 16 – Residential Securities Activity by Collateral Type

| Three Months Ended September 30, 2016<br>(In Thousands) | Senior   | Re-REMIC<br>(1) | Subordinate | Total     |
|---|----------|-----------------|-------------|-----------|
| Beginning fair value                                    | \$96,456 | \$165,707       | \$573,518   | \$835,681 |
| Transfers   | 1,476    | (1,476 )        | —           | —         |
| Acquisitions  |          |                 |             |           |
| Sequoia securities                                      | —        | —               | 1,839       | 1,839     |
| Third-party securities                                  | —        | —               | 48,373      | 48,373    |
| Sales   |          |                 |             |           |
| Sequoia securities                                      | —        | —               | (26,288 )   | (26,288 ) |
| Third-party securities                                  | —        | —               | —           | —         |
| Gains on sales and calls, net                           | —        | —               | 1,990       | 1,990     |
| Effect of principal payments (2)                        | (4,552 ) | (4,917 )        | (7,985 )    | (17,454 ) |
| Change in fair value, net                               | 2,402    | 1,920           | 15,837      | 20,159    |
| Ending Fair Value                                       | \$95,782 | \$161,234       | \$607,284   | \$864,300 |

| Nine Months Ended September 30, 2016<br>(In Thousands) | Senior     | Re-REMIC <sup>(1)</sup> | Subordinate | Total       |
|--|------------|-------------------------|-------------|-------------|
| Beginning fair value                                   | \$336,595  | \$ 165,064              | \$ 526,512  | \$1,028,171 |
| Transfers  | 1,476      | (1,476 )                | —           | —           |
| Acquisitions   |            |                         |             |             |
| Sequoia securities                                     | —          | —                       | 5,152       | 5,152       |
| Third-party securities                                 | —          | —                       | 146,125     | 146,125     |
| Sales  |            |                         |             |             |
| Sequoia securities                                     | (21,016 )  | —                       | (51,034 )   | (72,050 )   |
| Third-party securities                                 | (185,087 ) | —                       | (28,884 )   | (213,971 )  |
| Gains on sales and calls, net                          | 15,598     | —                       | 5,714       | 21,312      |
| Effect of principal payments <sup>(2)</sup>            | (22,836 )  | (4,930 )                | (24,712 )   | (52,478 )   |
| Change in fair value, net                              | (28,948 )  | 2,576                   | 28,411      | 2,039       |
| Ending Fair Value                                      | \$95,782   | \$ 161,234              | \$ 607,284  | \$864,300   |

(1) Re-REMIC securities, as presented herein, were created by third parties through the resecuritization of certain senior RMBS.

The effect of principal payments reflects the change in fair value due to principal payments, which is calculated as (2) the cash principal received on a given security during the period multiplied by the prior quarter ending price or acquisition price for that security.

At September 30, 2016, our residential securities consisted of fixed-rate assets (71%), adjustable-rate assets (17%), hybrid assets that reset within the next year (11%), and hybrid assets that reset between 12 and 36 months (1%). The following table presents the fair value of our residential securities that are financed with repurchase debt at September 30, 2016.

Table 17 – Residential Securities Financed with Repurchase Debt  
September 30, 2016

| (Dollars in Thousands, except Weighted Average Price) | Residential Securities | Repurchase Debt | Allocated Capital | Weighted Average Price <sup>(1)</sup> | Financing Haircut <sup>(2)</sup> |
|---|------------------------|-----------------|-------------------|---------------------------------------|----------------------------------|
| Residential Securities                                |                        |                 |                   |                                       |                                  |
| Senior  | \$ 54,871              | \$(47,296 )     | \$ 7,575          | \$ 93                                 | 14 %                             |
| Mezzanine   | 280,937                | (232,263 )      | 48,674            | 100                                   | 17 %                             |
| Total   | \$ 335,808             | \$(279,559)     | \$ 56,249         | 99                                    | 17 %                             |

(1) GAAP fair value per \$100 of principal.

(2) Allocated capital divided by GAAP fair value.

We directly finance our holdings of residential securities with a combination of capital and collateralized debt in the form of repurchase (or “repo”) financing. At September 30, 2016, we had short-term debt incurred through repurchase facilities of \$280 million, which was secured by \$336 million of residential real estate securities. The remaining \$528 million of these securities were financed with capital. Our repo borrowings were made under facilities with seven different counterparties, and the weighted average cost of funds for these facilities during the third quarter of 2016 was approximately 1.86% per annum. At September 30, 2016, the securities we financed through repurchase facilities had no material credit issues. In addition to the allocated capital listed in the table above that directly supports our repurchase facilities (the “financing haircut”), we continue to hold a designated amount of supplemental risk capital available for potential margin calls or future obligations relating to these facilities.

The majority of the \$55 million of senior securities noted in the table above are supported by seasoned residential loans originated prior to 2008. The \$281 million of mezzanine securities financed through repurchase facilities at September 30, 2016, carry investment grade credit ratings and are supported by residential loans originated between 2012 and 2016. The loans underlying these securities have experienced minimal delinquencies to date.

The following table presents real estate securities at September 30, 2016 and December 31, 2015, categorized by portfolio vintage (the years the securities were issued), by priority of cash flows (senior, re-REMIC, and subordinate), and by quality of underlying loans (prime and non-prime). We have additionally separated securities issued through our Sequoia platform or by third parties, including the Agencies.

Table 18 – Residential Securities by Vintage and as a Percentage of Total Securities

| September 30, 2016<br>(Dollars in Thousands) | Sequoia<br>2012-2016 | Third Party<br>2013-2016 | Agency<br>CRT<br>2013-2016 | Third Party<br>2006-2008 | Third<br>Party<br><=2005 | Total<br>Securities | % of Total<br>Securities |   |
|--|----------------------|--------------------------|----------------------------|--------------------------|--------------------------|---------------------|--------------------------|---|
| Senior                                       |                      |                          |                            |                          |                          |                     |                          |   |
| Prime  | \$ 19,098            | \$ —                     | \$ —                       | \$ 12,633                | \$ 50,837                | \$ 82,568           | 10                       | % |
| Non-prime                                    | —                    | —                        | —                          | 111                      | 13,103                   | 13,214              | 1                        | % |
| Total Senior                                 | 19,098               | —                        | —                          | 12,744                   | 63,940                   | 95,782              | 11                       | % |
| Re-REMIC                                     | —                    | —                        | —                          | 104,404                  | 56,830                   | 161,234             | 19                       | % |
| Subordinate                                  |                      |                          |                            |                          |                          |                     |                          |   |
| Prime Mezzanine <sup>(1)</sup>               | 139,746              | 143,815                  | 16,129                     | —                        | —                        | 299,690             | 35                       | % |
| Prime Subordinate <sup>(2)</sup>             | 109,675              | 56,046                   | 118,331                    | 607                      | 22,935                   | 307,594             | 35                       | % |
| Total Subordinate                            | 249,421              | 199,861                  | 134,460                    | 607                      | 22,935                   | 607,284             | 70                       | % |
| Total Securities                             | \$ 268,519           | \$ 199,861               | \$ 134,460                 | \$ 117,755               | \$ 143,705               | \$ 864,300          | 100                      | % |
| December 31, 2015<br>(Dollars in Thousands)  | Sequoia<br>2012-2015 | Third Party<br>2012-2015 | Agency<br>CRT<br>2013-2015 | Third Party<br>2006-2008 | Third<br>Party<br><=2005 | Total<br>Securities | % of Total<br>Securities |   |
| Senior                                       |                      |                          |                            |                          |                          |                     |                          |   |
| Prime  | \$ 51,563            | \$ —                     | \$ —                       | \$ 36,358                | \$ 174,635               | \$ 262,556          | 26                       | % |
| Non-prime                                    | —                    | —                        | —                          | 133                      | 73,906                   | 74,039              | 7                        | % |
| Total Senior                                 | 51,563               | —                        | —                          | 36,491                   | 248,541                  | 336,595             | 33                       | % |
| Re-REMIC                                     | —                    | —                        | —                          | 108,594                  | 56,470                   | 165,064             | 16                       | % |
| Subordinate                                  |                      |                          |                            |                          |                          |                     |                          |   |
| Prime Mezzanine <sup>(1)</sup>               | 185,993              | 127,233                  | 34,976                     | —                        | —                        | 348,202             | 34                       | % |
| Prime Subordinate <sup>(2)</sup>             | 96,849               | 35,361                   | 13,244                     | 812                      | 32,044                   | 178,310             | 17                       | % |
| Total Subordinate                            | 282,842              | 162,594                  | 48,220                     | 812                      | 32,044                   | 526,512             | 51                       | % |
| Total Securities                             | \$ 334,405           | \$ 162,594               | \$ 48,220                  | \$ 145,897               | \$ 337,055               | \$ 1,028,171        | 100                      | % |

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

(2) Subordinate securities include less than \$1 million of non-prime securities at both September 30, 2016 and December 31, 2015.

The following tables present the components of the interest income we earned on AFS securities for the three and nine months ended September 30, 2016 and 2015.

Table 19 – Interest Income — Residential AFS Securities

Three Months Ended September 30,  
2016

| (Dollars in Thousands) | Interest<br>Income | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income | Average<br>Amortized<br>Cost | Yield as a Result of |                                       |                             |
|------------------------|--------------------|---------------------------------------|-----------------------------|------------------------------|----------------------|---------------------------------------|-----------------------------|
|                        |                    |                                       |                             |                              | Interest<br>Income   | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income |
| Residential            |                    |                                       |                             |                              |                      |                                       |                             |
| Senior                 | \$ 609             | \$ 529                                | \$1,138                     | \$ 68,219                    | 3.57%                | 3.10%                                 | 6.67%                       |
| Re-REMIC               | 1,799              | 3,596                                 | 5,395                       | 113,638                      | 6.33%                | 12.66%                                | 18.99%                      |
| Subordinate            |                    |                                       |                             |                              |                      |                                       |                             |
| Mezzanine              | 1,764              | 665                                   | 2,429                       | 180,108                      | 3.92%                | 1.48%                                 | 5.40%                       |
| Subordinate            | 2,473              | 1,334                                 | 3,807                       | 126,877                      | 7.80%                | 4.21%                                 | 12.01%                      |
| Total AFS Securities   | \$ 6,645           | \$ 6,124                              | \$12,769                    | \$ 488,842                   | 5.44%                | 5.01%                                 | 10.45%                      |

Three Months Ended September 30,  
2015

| (Dollars in Thousands) | Interest<br>Income | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income | Average<br>Amortized<br>Cost | Yield as a Result of |                                       |                             |
|------------------------|--------------------|---------------------------------------|-----------------------------|------------------------------|----------------------|---------------------------------------|-----------------------------|
|                        |                    |                                       |                             |                              | Interest<br>Income   | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income |
| Residential            |                    |                                       |                             |                              |                      |                                       |                             |
| Senior                 | \$3,276            | \$ 4,381                              | \$7,657                     | \$ 383,736                   | 3.41%                | 4.57%                                 | 7.98%                       |
| Re-REMIC               | 2,216              | 2,339                                 | 4,555                       | 105,571                      | 8.40%                | 8.86%                                 | 17.26%                      |
| Subordinate            |                    |                                       |                             |                              |                      |                                       |                             |
| Mezzanine              | 2,348              | 789                                   | 3,137                       | 234,204                      | 4.01%                | 1.35%                                 | 5.36%                       |
| Subordinate            | 2,318              | 1,606                                 | 3,924                       | 114,794                      | 8.08%                | 5.60%                                 | 13.67%                      |
| Total AFS Securities   | \$10,158           | \$ 9,115                              | \$19,273                    | \$ 838,305                   | 4.85%                | 4.35%                                 | 9.20%                       |

Nine Months Ended September 30, 2016

| (Dollars in Thousands) | Interest<br>Income | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income | Average<br>Amortized<br>Cost | Yield as a Result of |                                       |                             |
|------------------------|--------------------|---------------------------------------|-----------------------------|------------------------------|----------------------|---------------------------------------|-----------------------------|
|                        |                    |                                       |                             |                              | Interest<br>Income   | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income |
| Residential            |                    |                                       |                             |                              |                      |                                       |                             |
| Senior                 | \$3,594            | \$ 3,832                              | \$7,426                     | \$ 126,592                   | 3.79%                | 4.04%                                 | 7.83%                       |
| Re-REMIC               | 5,484              | 10,400                                | 15,884                      | 112,029                      | 6.53%                | 12.38%                                | 18.91%                      |
| Subordinate            |                    |                                       |                             |                              |                      |                                       |                             |
| Mezzanine              | 5,745              | 2,038                                 | 7,783                       | 193,643                      | 3.96%                | 1.40%                                 | 5.36%                       |
| Subordinate            | 7,119              | 4,261                                 | 11,380                      | 121,014                      | 7.84%                | 4.69%                                 | 12.53%                      |
| Total AFS Securities   | \$21,942           | \$ 20,531                             | \$42,473                    | \$ 553,278                   | 5.29%                | 4.95%                                 | 10.24%                      |

Nine Months Ended September 30, 2015

| (Dollars in Thousands) | Interest<br>Income | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income | Average<br>Amortized<br>Cost | Yield as a Result of |                                       |                             |
|------------------------|--------------------|---------------------------------------|-----------------------------|------------------------------|----------------------|---------------------------------------|-----------------------------|
|                        |                    |                                       |                             |                              | Interest<br>Income   | Discount<br>(Premium)<br>Amortization | Total<br>Interest<br>Income |
| Residential            |                    |                                       |                             |                              |                      |                                       |                             |
| Senior                 | \$10,640           | \$ 13,681                             | \$24,321                    | \$ 404,020                   | 3.51 %               | 4.51 %                                | 8.03 %                      |
| Re-REMIC               | 6,644              | 6,863                                 | 13,507                      | 103,414                      | 8.57 %               | 8.85 %                                | 17.41 %                     |
| Subordinate            |                    |                                       |                             |                              |                      |                                       |                             |
| Mezzanine              | 9,406              | 2,828                                 | 12,234                      | 308,986                      | 4.06 %               | 1.22 %                                | 5.28 %                      |
| Subordinate            | 7,050              | 4,905                                 | 11,955                      | 116,417                      | 8.07 %               | 5.62 %                                | 13.69 %                     |
| Total AFS Securities   | \$33,740           | \$ 28,277                             | \$62,017                    | \$ 932,837                   | 4.82 %               | 4.04 %                                | 8.86 %                      |

The following tables present the components of carrying value at September 30, 2016 and December 31, 2015 for our AFS residential securities.

Table 20 – Carrying Value of AFS Securities

| September 30, 2016<br>(In Thousands) | Senior    | Re-REMIC   | Subordinate | Total      |
|--------------------------------------|-----------|------------|-------------|------------|
| Principal balance                    | \$77,660  | \$ 180,754 | \$ 460,981  | \$ 719,395 |
| Credit reserve                       | (2,124 )  | (10,452 )  | (35,037 )   | (47,613 )  |
| Unamortized discount, net            | (7,751 )  | (59,146 )  | (135,829 )  | (202,726 ) |
| Amortized cost                       | 67,785    | 111,156    | 290,115     | 469,056    |
| Gross unrealized gains               | 5,585     | 50,078     | 74,041      | 129,704    |
| Gross unrealized losses              | (2,080 )  | —          | (1,039 )    | (3,119 )   |
| Carrying Value                       | \$71,290  | \$ 161,234 | \$ 363,117  | \$ 595,641 |
| December 31, 2015<br>(In Thousands)  | Senior    | Re-REMIC   | Subordinate | Total      |
| Principal balance                    | \$293,196 | \$ 189,782 | \$ 490,249  | \$ 973,227 |
| Credit reserve                       | (6,406 )  | (10,332 )  | (32,131 )   | (48,869 )  |
| Unamortized discount, net            | (30,474 ) | (71,670 )  | (134,963 )  | (237,107 ) |
| Amortized cost                       | 256,316   | 107,780    | 323,155     | 687,251    |
| Gross unrealized gains               | 26,512    | 57,284     | 63,205      | 147,001    |
| Gross unrealized losses              | (3,577 )  | —          | (1,430 )    | (5,007 )   |
| Carrying Value                       | \$279,251 | \$ 165,064 | \$ 384,930  | \$ 829,245 |

We designate any amount of unpaid principal balance that we do not expect to receive and thus do not expect to earn or recover as a credit reserve on each security. Any remaining net unamortized discounts or premiums on the security are amortized into income over time using the effective yield method.

At September 30, 2016, credit reserves for our AFS securities totaled \$48 million, or 6.6% of the principal balance of our residential securities, as compared to \$49 million, or 5.0%, at December 31, 2015. During the nine months ended September 30, 2016, reductions in the credit reserve from realized losses and sales and transfers out of credit reserve to accretable discount were partially offset by increases resulting from acquisitions. During the three and nine months ended September 30, 2016 and 2015, realized credit losses on our residential securities totaled \$0.3 million and \$3 million, respectively, and \$2 million and \$7 million, respectively.



## Mortgage Servicing Rights Portfolio

Our MSR's are held and managed at our taxable REIT subsidiary and typically are acquired together with loans from originators and then separately recognized under GAAP when the MSR is retained and the associated loan is sold to a third party or transferred to a Sequoia residential securitization sponsored by us that meets the GAAP criteria for sale. In addition, we also purchase MSR's on a flow basis from third-parties that sell the associated loans directly to the Agencies and we may also purchase portfolios of MSR's on a bulk basis. Although we own the rights to service loans, we contract with sub-servicers to perform these activities. Our receipt of MSR income is not subject to any covenants other than customary performance obligations associated with servicing residential loans. If a sub-servicer we contract with was to fail to perform these obligations, our servicing rights could be terminated and we would evaluate our MSR asset for impairment at that time.

The following tables provide the activity for MSR's by portfolio for the three and nine months ended September 30, 2016 and 2015.

Table 21 – MSR Activity by Portfolio

| (In Thousands)                              | Three Months Ended September 30, 2016 |            |             | Nine Months Ended September 30, 2016 |            |             |
|---|---------------------------------------|------------|-------------|--------------------------------------|------------|-------------|
|   | Jumbo                                 | Conforming | Total MSR's | Jumbo                                | Conforming | Total MSR's |
| Balance at beginning of period              | \$31,750                              | \$ 78,296  | \$ 110,046  | \$58,138                             | \$ 133,838 | \$ 191,976  |
| Additions                                   |                                       |            |             |                                      |            |             |
| MSR's retained from Sequoia securitizations | 1,971                                 | —          | 1,971       | 4,102                                | —          | 4,102       |
| MSR's retained from third-party loan sales  | 21                                    | —          | 21          | 145                                  | 3,380      | 3,525       |
| Purchased MSR's                             | —                                     | 1,451      | 1,451       | —                                    | 15,314     | 15,314      |
| Sold MSR's                                  | —                                     | (8,860 )   | (8,860 )    | —                                    | (38,419 )  | (38,419 )   |
| Market valuation adjustments                | 2,689                                 | (1,309 )   | 1,380       | (25,954 )                            | (44,535 )  | (70,489 )   |
| Balance at End of Period                    | \$36,431                              | \$ 69,578  | \$ 106,009  | \$36,431                             | \$ 69,578  | \$ 106,009  |

During the nine months ended September 30, 2016, we sold MSR's with a fair value of \$38 million. In addition, subsequent to September 30, 2016, we entered into an agreement to sell conforming MSR's with a fair value of approximately \$25 million. We expect the transaction to settle in the fourth quarter of 2016. We may periodically sell MSR's in the future; however, we cannot predict the timing and amounts of such sales, if any.

The following table presents characteristics of the loans associated with our MSR investments at September 30, 2016.

Table 22 – Characteristics of MSR Investments Portfolio

| (Dollars In Thousands)                            | September 30, 2016 |             |              |
|---|--------------------|-------------|--------------|
|   | Jumbo              | Conforming  | Total        |
| Unpaid principal balance                          | \$5,494,950        | \$8,422,222 | \$13,917,172 |
| Fair value of MSR's                               | \$36,431           | \$69,578    | \$106,009    |
| MSR values as percent of unpaid principal balance | 0.66               | % 0.83      | % 0.76       |
| Gross cash yield <sup>(1)</sup>                   | 0.25               | % 0.27      | % 0.22       |
| Number of loans                                   | 7,978              | 36,591      | 44,569       |
| Average loan size                                 | \$689              | \$230       | \$312        |
| Average coupon                                    | 3.98               | % 3.91      | % 3.93       |
| Average loan age (months)                         | 33                 | 18          | 24           |
| Average original loan-to-value                    | 67                 | % 74        | % 71         |
| Average original FICO score                       | 770                | 759         | 764          |
| 60+ day delinquencies                             | 0.08               | % 0.21      | % 0.16       |

Gross cash yield is calculated by dividing the annualized quarterly gross servicing fees we received for the three (1) months ended September 30, 2016, by the weighted average notional balance of loans associated with MSR's we owned during that period.



At September 30, 2016, nearly all of our MSR's were comprised of base MSR's and we did not own any portion of a servicing right related to any loan where we did not own the entire servicing right. At both September 30, 2016 and December 31, 2015, we had \$1 million of servicer advances outstanding related to our MSR's, which are presented in Other assets on our consolidated balance sheets.

#### Residential Mortgage Banking Segment

The following table presents the components of segment contribution for the Residential Mortgage Banking segment for the three and nine months ended September 30, 2016 and 2015.

Table 23 – Residential Mortgage Banking Segment Contribution

| (In Thousands)                            | Three Months Ended September 30, 2016 |          |           | Nine Months Ended September 30, 2015 |          |           |
|---|---------------------------------------|----------|-----------|--------------------------------------|----------|-----------|
|   | 2016                                  | 2015     | Change    | 2016                                 | 2015     | Change    |
| Interest income                           |                                       |          |           |                                      |          |           |
| Loans                                     | \$8,831                               | \$12,115 | \$(3,284) | \$24,038                             | \$33,557 | \$(9,519) |
| Sequoia securities                        | —                                     | —        | —         | 572                                  | 4,329    | (3,757)   |
| Total interest income                     | 8,831                                 | 12,115   | (3,284)   | 24,610                               | 37,886   | (13,276)  |
| Interest expense                          | (3,826)                               | (4,313)  | 487       | (10,719)                             | (11,389) | 670       |
| Net interest income                       | 5,005                                 | 7,802    | (2,797)   | 13,891                               | 26,497   | (12,606)  |
| Mortgage banking activities, net          | 9,766                                 | 331      | 9,435     | 26,774                               | 7,383    | 19,391    |
| Direct operating expenses                 | (5,807)                               | (11,278) | 5,471     | (17,175)                             | (33,214) | 16,039    |
| Segment contribution before income taxes  | 8,964                                 | (3,145)  | 12,109    | 23,490                               | 666      | 22,824    |
| (Provision for) benefit from income taxes | (240)                                 | 2,690    | (2,930)   | (240)                                | 3,562    | (3,802)   |
| Segment Contribution                      | \$8,724                               | \$(455)  | \$9,179   | \$23,250                             | \$4,228  | \$19,022  |

The following tables provide the activity of unsecuritized residential loans during the three and nine months ended September 30, 2016 and 2015.

Table 24 – Residential Loans Held-for-Sale — Activity

| (In Thousands)                              | Three Months Ended September 30, 2016 |            |              | September 30, 2015 |             |             |
|---|---------------------------------------|------------|--------------|--------------------|-------------|-------------|
|   | Jumbo                                 | Conforming | Total        | Jumbo              | Conforming  | Total       |
| Balance at beginning of period              | \$882,380                             | \$         | —\$882,380   | \$643,924          | \$248,157   | \$892,081   |
| Acquisitions                                | 1,252,135                             | —          | 1,252,135    | 1,565,472          | 1,421,715   | 2,987,187   |
| Sales                                       | (774,106)                             | —          | (774,106)    | (695,138)          | (1,437,757) | (2,132,895) |
| Transfers between portfolios <sup>(1)</sup> | (151,919)                             | —          | (151,919)    | (233,429)          | —           | (233,429)   |
| Principal repayments                        | (20,574)                              | —          | (20,574)     | (17,021)           | (781)       | (17,802)    |
| Changes in fair value, net                  | 598                                   | —          | 598          | 6,029              | 4,980       | 11,009      |
| Balance at End of Period                    | \$1,188,514                           | \$         | —\$1,188,514 | \$1,269,837        | \$236,314   | \$1,506,151 |

| (In Thousands)                              | Nine Months Ended<br>September 30, 2016 |            |              | September 30, 2015 |              |              |
|---|---|------------|--------------|--------------------|--------------|--------------|
|   | Jumbo                                   | Conforming | Total        | Jumbo              | Conforming   | Total        |
| Balance at beginning of period              | \$985,919                               | \$129,819  | \$1,115,738  | \$1,097,805        | \$244,714    | \$1,342,519  |
| Acquisitions                                | 3,615,003                               | 197,860    | 3,812,863    | 4,084,952          | 4,227,014    | 8,311,966    |
| Sales                                       | (2,544,595 )                            | (329,620 ) | (2,874,215 ) | (2,972,887 )       | (4,241,550 ) | (7,214,437 ) |
| Transfers between portfolios <sup>(1)</sup> | (821,273 )                              | —          | (821,273 )   | (897,095 )         | —            | (897,095 )   |
| Principal repayments                        | (56,411 )                               | (84 )      | (56,495 )    | (45,322 )          | (1,371 )     | (46,693 )    |
| Changes in fair value, net                  | 9,871                                   | 2,025      | 11,896       | 2,384              | 7,507        | 9,891        |
| Balance at End of Period                    | \$1,188,514                             | \$—        | \$1,188,514  | \$1,269,837        | \$236,314    | \$1,506,151  |

<sup>(1)</sup> Represents the net transfers of loans into our Residential Investments segment and their reclassification from held-for-sale to held-for-investment.

The following table provides the activity of our retained Sequoia securities held in this segment for the three and nine months ended September 30, 2016 and 2015.

Table 25 – Sequoia Securities Activity

| (In Thousands)               | Three<br>Months<br>Ended<br>September<br>30, |      | Nine Months Ended<br>September 30, |           |
|------------------------------|--|------|------------------------------------|-----------|
|                              | 2016   | 2015 | 2016                               | 2015      |
| Beginning fair value         | \$ —   | \$ — | —                                  | —         |
| Transfers between portfolios | —  | —    | —                                  | (65,809 ) |
| Sales                        | —  | —    | (195,107 )                         | (13,588 ) |
| Effect of principal payments | —  | —    | (3,403 )                           | (98 )     |
| Change in fair value, net    | —  | —    | 1,503                              | (14,307 ) |
| Ending Fair Value            | \$ —   | \$ — | —                                  | —         |

#### Overview

During the first nine months of 2016, we purchased \$3.62 billion of predominately prime residential jumbo loans, sold \$2.54 billion of jumbo loans to third parties and securitized \$712 million through our Sequoia platform. In addition, we had net transfers of \$821 million of loans to our Residential Investments segment and financed them with borrowings from the FHLBC. Our pipeline of loans identified for purchase at September 30, 2016, included \$1.11 billion of jumbo loans. We substantially completed the wind-down of our conforming mortgage banking activities during the first quarter of 2016, having sold nearly all of our conforming loans and completed significant reductions in our headcount at this segment.

We utilize a combination of capital and our residential loan warehouse facilities to manage our inventory of residential loans held-for-sale. At September 30, 2016, we had \$838 million of warehouse debt outstanding to fund our residential loans held-for-sale. The weighted average cost of the borrowings outstanding under these facilities during the third quarter of 2016 was 2.09% per annum. Our warehouse capacity at September 30, 2016 totaled \$1.33 billion across four separate counterparties, which should continue to provide sufficient liquidity to fund our residential mortgage banking operations in the near-term.

Our residential mortgage banking operations created investments that allowed us to deploy \$112 million of capital into our residential investment portfolio during the first nine months of 2016. At September 30, 2016, we had 395 loan sellers, up from 330 at the end of 2015. This included 201 jumbo sellers and 194 MPF sellers from various FHLB districts.

Prior to the second quarter of 2015, this segment included Sequoia IO securities that were used in part to mitigate certain risks related to interest rate movements on our residential loan pipeline. During the second quarter of 2015, we permanently transferred all Sequoia IO securities from our Residential Mortgage Banking segment to our Residential Investments segment. In addition, in the fourth quarter of 2015, we retained senior securities from a Sequoia

securitization we sponsored that quarter, which we subsequently sold during the first quarter of 2016.

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### Net Interest Income

Net interest income from residential mortgage banking is primarily comprised of interest income earned on residential loans from the time we purchase the loans to when we sell or securitize them, offset by interest expense incurred on short-term warehouse debt used in part to finance the loans while we hold them on our consolidated balance sheet.

The \$3 million and \$13 million decreases in net interest income for the three and nine month periods, respectively, were primarily due to lower average balances of conforming loans during 2016, resulting from the wind-down of conforming loan purchases and sales during the first quarter of 2016. In addition, certain Sequoia securities that were included in this segment through the first quarter of 2015 and transferred into our Residential Investments segment in the second quarter of 2015, accounted for \$2 million of the decrease during the nine month periods.

The amount of net interest income we earn on loans held-for-sale is dependent on many variables, including the amount of loans and the time they are outstanding on our consolidated balance sheet and their interest rates, as well as the amount of leverage we employ through the use of short-term debt to finance the loans and the interest rates on that debt. These factors will impact interest income in future periods.

### Mortgage Banking Activities, Net

Mortgage banking activities, net, includes the changes in market value of both the loans we hold for sale and commitments for loans we intend to purchase (collectively, our loan pipeline), as well as the effect of hedges we utilize to manage risks associated with our loan pipeline. Our loan sale profit margins are measured over the period from when we commit to purchase a loan and subsequently sell or securitize the loan. Accordingly, these profit margins may encompass positive or negative market valuation adjustments on loans, hedging gains or losses associated with our loan pipeline, and any other related transaction expenses, and may be realized over the course of one or more quarters for financial reporting purposes.

The following table presents the components of residential mortgage banking activities, net. Amounts presented include both the changes in market values for loans that were sold and associated derivative positions that were settled during the periods presented, as well as changes in market values of loans, derivatives and hedges outstanding at the end of each period.

Table 26 – Components of Residential Mortgage Banking Activities, Net

| (In Thousands)  | Three Months<br>Ended September<br>30, |          |            | Nine Months<br>Ended September<br>30, |          |           |
|---|--|----------|------------|---------------------------------------|----------|-----------|
|   | 2016                                   | 2015     | Change     | 2016                                  | 2015     | Change    |
| Changes in fair value of:                             |  |          |            |                                       |          |           |
| Residential loans, at fair value <sup>(1)</sup>       | \$12,671                               | \$36,183 | \$(23,512) | \$47,456                              | \$54,375 | \$(6,919) |
| Sequoia securities                                    | —                                      | —        | —          | 1,455                                 | (14,359) | 15,814    |
| Risk management derivatives <sup>(2)</sup>            | (3,287)                                | (37,029) | 33,742     | (22,743)                              | (35,842) | 13,099    |
| Other income, net <sup>(3)</sup>                      | 382                                    | 1,177    | (795)      | 606                                   | 3,209    | (2,603)   |
| Total Residential Mortgage Banking<br>Activities, Net | \$9,766                                | \$331    | \$9,435    | \$26,774                              | \$7,383  | \$19,391  |

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

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

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

The increases in mortgage banking activities, net in both the three and nine month periods was primarily due to higher jumbo gross margins during 2016 on similar volume as compared to the prior year.

Loan purchase commitments ("LPCs"), adjusted for fallout expectations, were \$1.17 billion and \$3.63 billion, respectively, for the three and nine months ended September 30, 2016. Our gross margins for our jumbo loans, which we define as net interest income plus income from mortgage banking activities, divided by LPCs, were 126 basis points in the third quarter of 2016 and 107 basis points for the first nine months of 2016. In both cases, the margins were above our long-term expectations of 50 to 75 basis points. Gross margins for the third quarter of 2016 benefited from improved pricing on securitization execution, relative to prior quarters.



At September 30, 2016, we had a repurchase reserve of \$5 million outstanding related to residential loans sold through this segment. For the nine months ended September 30, 2016 and 2015, we recorded \$0.5 million and \$2 million, respectively, of provision for repurchases that was included in income from mortgage banking activities, net, in this segment. We review our loan repurchase reserves each quarter and adjust them as necessary based on current information available at each reporting date.

The following table details outstanding principal balances for residential loans held-for-sale by product type at September 30, 2016.

Table 27 – Characteristics of Residential Loans Held-for-Sale

| September 30, 2016<br>(Dollars in Thousands) | Principal<br>Value | Weighted<br>Average<br>Coupon |
|--|--------------------|-------------------------------|
| First Lien Prime                             |                    |                               |
| Fixed - 30 year                              | \$596,066          | 4.15 %                        |
| Fixed - 15, 20, & 25 year                    | 102,757            | 3.34 %                        |
| Hybrid                                       | 459,059            | 3.26 %                        |
| Total Outstanding Principal                  | \$1,157,882        |                               |

#### Operating Expenses and Taxes

The decreases in operating expenses in both the three and nine month periods at this segment were primarily attributable to the restructuring of our conforming loan mortgage banking operations during the first quarter of 2016. All severance and related charges from the restructuring of our conforming mortgage banking operations were included in corporate/other for segment reporting purposes. Our 2016 operating expenses primarily include costs associated with the underwriting, purchase and sale of jumbo residential loans.

All residential mortgage banking activities are performed at our taxable REIT subsidiary and the provision for income taxes is generally correlated to the amount of this segment's contribution before income taxes in relation to the TRS's overall GAAP income and associated tax provision.

#### Commercial Segment

The following table presents the components of segment contribution for the Commercial segment for the three and nine months ended September 30, 2016 and 2015.

Table 28 – Commercial Segment Contribution

| (In Thousands)                            | Three Months<br>Ended September<br>30, |          |           | Nine Months<br>Ended September<br>30, |          |           |
|---|--|----------|-----------|---------------------------------------|----------|-----------|
|   | 2016                                   | 2015     | Change    | 2016                                  | 2015     | Change    |
| Interest income                           | \$7,195                                | \$11,191 | \$(3,996) | \$29,927                              | \$34,784 | \$(4,857) |
| Interest expense                          | (542)                                  | (3,502)  | 2,960     | (5,001)                               | (10,488) | 5,487     |
| Net interest income                       | 6,653                                  | 7,689    | (1,036)   | 24,926                                | 24,296   | 630       |
| Reversal of provision for loan losses     | 859                                    | 60       | 799       | 7,102                                 | 115      | 6,987     |
| Mortgage banking activities, net          | —                                      | 1,002    | (1,002)   | (2,062)                               | 3,323    | (5,385)   |
| Investment fair value changes, net        | 203                                    | —        | 203       | 408                                   | —        | 408       |
| Other income                              | —                                      | —        | —         | 27                                    | —        | 27        |
| Realized gains, net                       | 4,624                                  | —        | 4,624     | 4,433                                 | —        | 4,433     |
| Direct operating expenses                 | (253)                                  | (3,136)  | 2,883     | (2,524)                               | (9,638)  | 7,114     |
| Segment contribution before income taxes  | 12,086                                 | 5,615    | 6,471     | 32,310                                | 18,096   | 14,214    |
| (Provision for) benefit from income taxes | —                                      | (389)    | 389       | —                                     | 321      | (321)     |
| Total Segment Contribution                | \$12,086                               | \$5,226  | \$6,860   | \$32,310                              | \$18,417 | \$13,893  |





The following table provides the activity of commercial loans during the nine months ended September 30, 2016 and 2015.

Table 29 – Commercial Loans — Activity

| (In Thousands)                        | Nine Months Ended September 30, |                     |               |                     |
|---------------------------------------|---------------------------------|---------------------|---------------|---------------------|
|                                       | 2016                            |                     | 2015          |                     |
|                                       | Held-for-Sale                   | Held-for-Investment | Held-for-Sale | Held-for-Investment |
| Balance at beginning of period        | \$39,141                        | \$ 363,506          | \$166,234     | \$ 400,693          |
| Originations/acquisitions             | 37,625                          | —                   | 517,894       | 22,219              |
| Sales                                 | (350,521)                       | —                   | (614,024)     | —                   |
| Transfers between portfolios          | 302,580                         | (302,580)           | —             | —                   |
| Principal repayments                  | (3,361)                         | (70,529)            | (167)         | (35,441)            |
| Discount amortization                 | —                               | 330                 | —             | 565                 |
| Reversal of provision for loan losses | —                               | 7,102               | —             | 115                 |
| Changes in fair value, net            | 4,936                           | 2,171               | 10,819        | (750)               |
| Balance at End of Period              | \$30,400                        | \$ —                | \$80,756      | \$ 387,401          |

### Overview

During the first quarter of 2016, we sold all of our remaining commercial senior loans, completed significant reductions in our headcount at this segment, and substantially completed the wind-down of our commercial mortgage banking activities. During the third quarter of 2016, we sold the majority of our commercial mezzanine loan portfolio, which resulted in realized gains of \$5 million, and currently expect to settle the sale of \$27 million of our remaining \$30 million of commercial loans in the fourth quarter of 2016.

During 2016, substantially all of the income from this segment was derived from our commercial investments. At September 30, 2016, these investments had a carrying value of \$104 million, and included \$30 million of commercial loans held-for-sale, and \$73 million of primarily multi-family commercial mortgage-backed securities (or "CMBS").

### Net Interest Income

During 2016, net interest income was primarily generated from our mezzanine and other subordinate commercial loans and securities. During 2015, interest income was also generated from senior loans we originated and sold to third-party CMBS aggregators. The following table presents net interest income from each of these portfolios for the three and nine months ended September 30, 2016 and 2015.

Table 30 Commercial Loans and Securities - Net Interest Income

| (In Thousands)             | Three Months        |         |           | Nine Months         |          |           |
|----------------------------|---------------------|---------|-----------|---------------------|----------|-----------|
|                            | Ended September 30, |         |           | Ended September 30, |          |           |
|                            | 2016                | 2015    | Change    | 2016                | 2015     | Change    |
| Senior loans held-for-sale | \$—                 | \$789   | \$(789)   | \$356               | \$2,129  | \$(1,773) |
| Mezzanine loans            | 5,911               | 6,900   | (989)     | 23,506              | 22,167   | 1,339     |
| Trading securities         | 742                 | —       | 742       | 1,064               | —        | 1,064     |
| Net Interest Income        | \$6,653             | \$7,689 | \$(1,036) | \$24,926            | \$24,296 | \$630     |

The \$1 million decrease in net interest income from our Commercial segment for the three month periods was primarily due to lower average balances of commercial mezzanine loans resulting from loan sales and repayments during the past 12 months. The \$1 million increase for the nine month periods was primarily due to \$5 million of prepayment penalty interest received in the second quarter of 2016, as compared with \$2 million received during the nine month period of 2015. This increase was partially offset by lower average balances of commercial mezzanine loans resulting from loan sales and repayments during the past 12 months.

### Reversal of Provision for Loan Losses

The increase in the reversal of provision for loan losses in the three month periods was primarily due to loan repayments during the third quarter of 2016. The increase in the reversal of provision for loan losses in the nine month periods was primarily due to the reclassification of most of our commercial mezzanine loans to held-for-sale classification at the lower of cost or market in the second quarter of 2016, whereby we determined an allowance was no longer required for the loans.

### Mortgage Banking Activities, Net

The loss from mortgage banking activities for the nine months ended September 30, 2016, resulted from the liquidation of our remaining senior loans during the first quarter of 2016 when we wound down those operations.

### Direct Operating Expenses and Taxes

The decrease in operating expenses in both the three and nine month periods at this segment was primarily attributable to the restructuring of our commercial mortgage banking operations during the first quarter of 2016. All severance and related charges from the restructuring of these operations were included in Corporate/Other for segment reporting purposes. Our 2016 operating expenses primarily include costs associated with the management of our commercial mezzanine loan portfolio.

### Commercial Mezzanine Loan Portfolio

Our commercial mezzanine loan portfolio is comprised of mezzanine and other subordinate loans that we previously originated. During the third quarter of 2016, we entered into an agreement with a third party to sell the majority of our commercial mezzanine loans and, as of September 30, 2016, had completed the sale of loans with a principal balance of \$203 million, which resulted in gains of \$5 million that are presented in Realized gains, net on our consolidated statements of income. At September 30, 2016, we held six loans, of which five are pending sale pursuant to the sale agreement entered into during the third quarter of 2016, subject to the satisfaction of certain conditions. The remaining loan had a carrying value of \$3 million at September 30, 2016, and during the third quarter of 2016, this loan experienced a technical default and we recorded a valuation adjustment of \$0.3 million through Investment fair value changes, net, a component of our consolidated statements of income.

### Results of Consolidated Sequoia Entities

We sponsored Sequoia securitization entities prior to 2012 that are reported on our consolidated balance sheets for financial reporting purposes in accordance with GAAP. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not, respectively, owned by us or legal obligations of ours. We record the assets and liabilities of the consolidated Sequoia entities at fair value, based on the estimated fair value of the debt securities (ABS) issued from the securitizations, in accordance with GAAP provisions for collateralized financing entities. At September 30, 2016, the estimated fair value of our investments in the consolidated Sequoia entities was \$27 million.

The following tables present the statements of income for the three and nine months ended September 30, 2016, and the balance sheets of the consolidated Sequoia entities at September 30, 2016 and December 31, 2015. All amounts in the statements of income and balance sheets presented below are included in our consolidated financial statements.

Table 31 – Consolidated Sequoia Entities Statements of Income

| (In Thousands)                                | Three Months  |          |           | Nine Months     |           |           |
|---|---------------|----------|-----------|-----------------|-----------|-----------|
|   | Ended         |          |           | Ended September |           |           |
|   | September 30, |          |           | 30,             |           |           |
|   | 2016          | 2015     | Change    | 2016            | 2015      | Change    |
| Interest income                               | \$4,837       | \$6,098  | \$(1,261) | \$14,525        | \$19,578  | \$(5,053) |
| Interest expense                              | (3,274 )      | (3,842 ) | 568       | (9,842 )        | (12,372 ) | 2,530     |
| Net interest income                           | 1,563         | 2,256    | (693 )    | 4,683           | 7,206     | (2,523 )  |
| Investment fair value changes, net            | (255 )        | (501 )   | 246       | (2,086 )        | (2,277 )  | 191       |
| Net Income from Consolidated Sequoia Entities | \$1,308       | \$1,755  | \$(447 )  | \$2,597         | \$4,929   | \$(2,332) |



Table 32 – Consolidated Sequoia Entities Balance Sheets

| (In Thousands)  | September<br>30, 2016 | December<br>31, 2015 |
|---|-----------------------|----------------------|
| Residential loans held for investment, at fair value              | \$ 839,976            | \$ 1,021,870         |
| Other assets  | 7,423                 | 6,254                |
| Total Assets  | \$ 847,399            | \$ 1,028,124         |
| Other liabilities   | \$ 523                | \$ 655               |
| Asset-backed securities issued, at fair value                     | 819,868               | 996,820              |
| Total liabilities   | 820,391               | 997,475              |
| Equity (fair value of Redwood's retained investments in entities) | 27,008                | 30,649               |
| Total Liabilities and Equity                                      | \$ 847,399            | \$ 1,028,124         |

## Net Interest Income at Consolidated Sequoia Entities

The decreases in net interest income in both the three and nine month periods from these entities primarily resulted from a lower average balance of loans outstanding at the entities during 2016, resulting from continued loan paydowns.

## Investment Fair Value Changes, Net at Consolidated Sequoia Entities

Investment fair value changes, net at consolidated Sequoia entities includes the change in fair value of the residential loans held-for-investment, REO, and the ABS issued at the entities, which netted together represent the change in value of our retained investments in the consolidated Sequoia entities. The decrease in market value during the first nine months of 2016 was primarily driven by a reduction in the basis of our retained IO securities from payments during that period.

## Residential Loans at Consolidated Sequoia Entities

The following table provides details of residential loan activity at consolidated Sequoia entities for the three and nine months ended September 30, 2016 and 2015.

Table 33 – Residential Loans at Consolidated Sequoia Entities — Activity

| (In Thousands)                  | Three Months Ended |              | Nine Months Ended |              |
|---------------------------------|--------------------|--------------|-------------------|--------------|
|                                 | September 30,      |              | September 30,     |              |
|                                 | 2016               | 2015         | 2016              | 2015         |
| Balance at beginning of period  | \$ 880,197         | \$ 1,237,114 | \$ 1,021,870      | \$ 1,474,386 |
| ASU 2014-13 election adjustment | —                  | —            | —                 | (103,649 )   |
| Adjusted beginning balance      | 880,197            | 1,237,114    | 1,021,870         | 1,370,737    |
| Principal repayments            | (46,810 )          | (65,556 )    | (147,748 )        | (201,353 )   |
| Transfers to REO                | (2,612 )           | (893 )       | (8,412 )          | (4,050 )     |
| Deconsolidation adjustments     | —                  | —            | (6,871 )          | —            |
| Changes in fair value, net      | 9,201              | (419 )       | (18,863 )         | 4,912        |
| Balance at End of Period        | \$ 839,976         | \$ 1,170,246 | \$ 839,976        | \$ 1,170,246 |

## Characteristics of Loans at Consolidated Sequoia Entities

The following table highlights unpaid principal balances for loans at consolidated Sequoia entities by product type at September 30, 2016.

Table 34 – Characteristics of Loans at Consolidated Sequoia Entities  
September 30, 2016

| (Dollars in Thousands)      | Principal Balance | Weighted Average Coupon |
|-----------------------------|-------------------|-------------------------|
| First Lien                  |                   |                         |
| Hybrid <sup>(1)</sup>       | \$19,100          | 2.94 %                  |
| ARM                         | 923,977           | 2.02 %                  |
| Total Outstanding Principal | \$943,077         |                         |

(1) All of these loans have reached the initial interest rate reset date and are currently adjustable rate mortgages. First lien adjustable rate mortgage ("ARM") and hybrid loans comprise nearly all of the loans in the consolidated Sequoia entities and were primarily originated in 2006 or prior. All of the \$19 million of hybrid loans held at consolidated Sequoia entities at September 30, 2016 had reset in 2010, and now act as ARM loans. For outstanding loans at consolidated Sequoia entities at September 30, 2016, the weighted average FICO score of borrowers backing these loans was 728 (at origination) and the weighted average original LTV ratio was 66% (at origination). At September 30, 2016 and December 31, 2015, the unpaid principal balance of loans at consolidated Sequoia entities delinquent greater than 90 days was \$19 million and \$27 million, respectively, and the unpaid principal balance of loans in foreclosure was \$18 million and \$32 million, respectively.

## Taxable Income and Tax Provision

## Taxable Income

The following table summarizes our taxable income and distributions to shareholders for the three and nine months ended September 30, 2016 and 2015. For each of these periods, we had no undistributed REIT taxable income.

Table 35 – Taxable Income

| (In Thousands, except per Share Data)   | Three Months Ended September 30, |          | Nine Months Ended September 30, |           |
|---|----------------------------------|----------|---------------------------------|-----------|
|   | 2016 est. <sup>(1)</sup>         | 2015     | 2016 est. <sup>(1)</sup>        | 2015      |
| REIT taxable income                     | \$26,001                         | \$23,717 | \$71,169                        | \$56,440  |
| Taxable REIT subsidiary income (loss)   | 10,896                           | (408 )   | 41,010                          | (29,869 ) |
| Total Taxable Income                    | \$36,897                         | \$23,309 | \$112,179                       | \$26,571  |
| REIT taxable income per share           | \$0.34                           | \$0.29   | \$0.93                          | \$0.68    |
| Total taxable income per share          | \$0.48                           | \$0.29   | \$1.46                          | \$0.33    |
| Distributions to shareholders           | \$21,536                         | \$23,318 | \$64,759                        | \$70,322  |
| Distributions to shareholders per share | \$0.28                           | \$0.28   | \$0.84                          | \$0.84    |

(1) Our tax results for the three and nine months ended September 30, 2016 are estimates until we file tax returns for this year.

We currently expect all or nearly all of the dividends we distribute in 2016 will be taxable to shareholders as ordinary income and a smaller portion, if any, will be a return of capital, which is in general, non-taxable. However, based on federal income tax rules related to capital loss carryforwards, none of our 2016 dividend distributions are expected to be characterized as long-term capital gains for federal income tax purposes.

Our estimated total taxable income for each of the three months ended September 30, 2016 and 2015 included \$1 million in realized credit losses on investments. Our estimated total taxable income for the nine months ended September 30, 2016 and 2015 included \$6 million and \$5 million in realized credit losses on investments, respectively. For tax purposes, we anticipate an additional \$22 million of credit losses to be realized over an estimated three- to five-year period based on the securities we currently own. For the three and nine months ended September 30, 2016, we realized net capital gains of \$2 million and \$18 million, respectively, at the REIT for tax purposes.

#### Tax Provision under GAAP

For both the three and nine months ended September 30, 2016, we recorded a tax provision of \$1 million compared to a tax benefit of \$7 million and a tax benefit of \$10 million for the three and nine months ended September 30, 2015, respectively. Our tax provision or benefit is primarily derived from the activities at our TRS as we do not book a material tax provision associated with income generated at our REIT. The change in tax provision (benefit) year-over-year was primarily the result of a valuation allowance being recorded against the net capital deferred tax assets ("DTAs"), which were generated from GAAP losses at our TRS in 2016. The income or loss generated at our TRS will not affect the tax characterization of our 2016 dividends.

Realization of our DTAs is dependent on many factors, including generating sufficient taxable income prior to the expiration of NOL carryforwards and generating sufficient capital gains in future periods prior to the expiration of capital loss carryforwards. We determine the extent to which realization of our DTAs is not assured and establish a valuation allowance accordingly. At December 31, 2015, we reported net federal ordinary and capital DTAs, for which we recorded a full valuation allowance. As a result of GAAP losses on capital assets at our TRS in the first three quarters of 2016, we are forecasting that we will report net federal capital DTAs at December 31, 2016. We remain uncertain about our ability to generate sufficient capital gains in future periods needed to utilize net capital DTAs beyond the reversal of our deferred tax liabilities, and included a valuation allowance against these forecasted DTAs in the calculation of our estimated annual effective tax rate. However, as a result of GAAP ordinary income at our TRS, we are forecasting that we will report net federal ordinary deferred tax liabilities ("DTLs") at December 31, 2016 and consequently no valuation allowance is expected to be recorded against any federal ordinary DTA. Consistent with prior periods, we continued to maintain a valuation allowance against our net state DTAs. Our estimate of net deferred tax assets could change in future periods to the extent that actual or revised estimates of future taxable income during the carryforward periods change from current expectations.

#### Differences between Estimated Total Taxable Income and GAAP Income

Differences between estimated taxable income and GAAP income are largely due to the following: (i) we cannot establish loss reserves for future anticipated events for tax but we can for GAAP, as realized credit losses are expensed when incurred for tax and these losses are anticipated through lower yields on assets or through loss provisions for GAAP; (ii) the timing, and possibly the amount, of some expenses (e.g., certain compensation expenses) are different for tax than for GAAP; (iii) since amortization and impairments differ for tax and GAAP, the tax and GAAP gains and losses on sales may differ, resulting in differences in realized gains on sale; (iv) at the REIT and certain TRS entities, unrealized gains and losses on market valuation adjustments of securities and derivatives are not recognized for tax until the instrument is sold or extinguished; (v) for tax, basis may not be assigned to mortgage servicing rights retained when whole loans are sold resulting in lower tax gain on sale; and, (vi) for tax, we do not consolidate securitization entities as we do under GAAP. As a result of these differences in accounting, our estimated taxable income can vary significantly from our GAAP income during certain reporting periods.

The tables below reconcile our estimated total taxable income to our GAAP income for the nine months ended September 30, 2016.

Table 36 – Differences between Estimated Total Taxable Income and GAAP Net Income

| (In Thousands, except per Share Data) | Nine Months Ended September 30, 2016 |               |                     |           |             |
|---------------------------------------|--------------------------------------|---------------|---------------------|-----------|-------------|
|                                       | REIT<br>(Est.)                       | TRS<br>(Est.) | Total Tax<br>(Est.) | GAAP      | Differences |
| Interest income                       | \$152,002                            | \$25,451      | \$177,453           | \$190,021 | \$(12,568 ) |
| Interest expense                      | (37,677 )                            | (21,898 )     | (59,575 )           | (67,991 ) | 8,416       |
| Net interest income                   | 114,325                              | 3,553         | 117,878             | 122,030   | (4,152 )    |
| Reversal of provision for loan losses | —                                    | —             | —                   | 7,102     | (7,102 )    |
| Realized credit losses                | (5,742 )                             | (1 )          | (5,743 )            | —         | (5,743 )    |
| Mortgage banking activities, net      | —                                    | 16,952        | 16,952              | 24,712    | (7,760 )    |
| MSR income, net                       | —                                    | 55,833        | 55,833              | 12,834    | 42,999      |
| Investment fair value changes, net    | (1,478 )                             | (4,174 )      | (5,652 )            | (18,686 ) | 13,034      |
| Operating expenses                    | (36,757 )                            | (32,465 )     | (69,222 )           | (70,962 ) | 1,740       |
| Other income                          | 840                                  | 1,082         | 1,922               | 4,157     | (2,235 )    |
| Realized gains, net                   | —                                    | 284           | 284                 | 26,037    | (25,753 )   |
| Provision for income taxes            | (19 )                                | (54 )         | (73 )               | (1,327 )  | 1,254       |
| Net Income                            | \$71,169                             | \$41,010      | \$112,179           | \$105,897 | \$6,282     |
| Income per basic common share         | \$0.93                               | \$0.53        | \$1.46              | \$1.34    | \$0.12      |

#### Potential Taxable Income Volatility

We expect period-to-period volatility in our estimated taxable income. A description of the factors that can cause this volatility is described in the Taxable Income portion of the "Results of Operations" section in the MD&A included in Part II, Item 7, of our Annual Report on Form 10-K.



## LIQUIDITY AND CAPITAL RESOURCES

### Summary

Our principal sources of cash consist of borrowings under mortgage loan warehouse facilities, securities repurchase agreements, payments of principal and interest we receive from our residential and commercial investment portfolios, and cash generated from our operating activities. Our most significant uses of cash are to purchase mortgage loans for our mortgage banking operations, to fund investments in residential loans, to purchase investment securities, to repay principal and interest on our warehouse facilities, repurchase agreements, and long-term debt, to make dividend payments on our capital stock, and to fund our operations.

Our total capital was \$1.75 billion at September 30, 2016, and included \$1.13 billion of equity capital and \$0.62 billion of the total \$2.62 billion of long-term debt on our consolidated balance sheet. This portion of long-term debt included \$140 million of trust-preferred securities due in 2037, \$288 million of convertible debt due in 2018, and \$201 million of exchangeable debt due in 2019. At September 30, 2016, we estimate that our capital available for investments was approximately \$300 million.

In August 2015, our Board of Directors authorized the repurchase of up to \$100 million of our common stock. During the nine months ended September 30, 2016, we repurchased 839,130 common shares for \$11 million, utilizing the remaining availability under this authorization.

In February 2016, our Board of Directors authorized the repurchase of up to \$100 million of our common stock and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. This authorization replaced all previous share repurchase plans and has no expiration date. This repurchase authorization does not obligate us to acquire any specific number of shares or securities. Under this authorization, shares or securities may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. During the nine months ended September 30, 2016, we repurchased 1,078,743 shares for \$14 million pursuant to this new authorization. At September 30, 2016, approximately \$86 million of this current authorization remained available for the repurchases of shares of our common stock. Like other investments we may make, any repurchases of our common stock under this authorization would reduce our available capital described above.

While we believe our available capital is sufficient to fund our currently contemplated investment activities, we may raise capital from time-to-time to make long-term investments or for other purposes. To the extent we seek additional capital to fund our operations and investment activities, our approach to raising capital will continue to be based on what we believe to be in the best long-term interests of shareholders. Any future capital raising transaction could include the issuance of debt or equity securities under the shelf registration statement we currently have on file with the SEC or the issuance of similar or other types of securities in public or private offerings.

We are subject to risks relating to our liquidity and capital resources, including risks relating to incurring debt under residential and commercial loan warehouse facilities, securities repurchase facilities, and other short- and long-term debt facilities and other risks relating to our use of derivatives. A further discussion of these risks is set forth below under the heading "Risks Relating to Debt Incurred under Short-and Long-Term Borrowing Facilities."

### Cash Flows and Liquidity for the Nine Months Ended September 30, 2016

Cash flows from our mortgage banking activities and our investments can be volatile from quarter to quarter depending on many factors, including the timing and amount of loan and securities acquisitions and sales and repayments, the profitability of mortgage banking activities, as well as changes in credit losses, prepayments, and interest rates. Therefore, cash flows generated in the current period are not necessarily reflective of the long-term cash flows we will receive from these investments or activities.

### Cash Flows from Operating Activities

Cash flows used in operating activities were \$756 million during the nine months ended September 30, 2016. This amount includes the net cash utilized during the period from the purchase and sale of residential and commercial mortgage loans associated with our mortgage banking activities. Purchases of loans are financed to a large extent with short-term debt, for which changes in cash are included as a component of financing activities. Cash flows for the nine months ended September 30, 2016 benefited from the restructuring of our conforming and commercial mortgage banking activities, whereby cash inflows from sales of loans associated with these activities during the first quarter of 2016 were not offset by ongoing outflows of cash as we discontinued the purchase of these types of loans. Excluding cash flows from the purchase, sale, and principal payments of loans classified as held-for-sale, cash flows from operating activities were positive \$75 million and negative \$43 million during the first nine months of 2016 and 2015, respectively.

Additionally, cash flows from operating activities were reduced by the purchase of \$9 million of FHLBC stock during the first nine months of 2016. Under our FHLB-member subsidiary's borrowing agreement with the FHLBC, our subsidiary must purchase and hold stock in the FHLBC in an amount equal to a specified percentage of outstanding advances.

### Cash Flows from Investing Activities

During the nine months ended September 30, 2016, our net cash provided by investing activities was \$1.15 billion and primarily resulted from principal payments on loans held-for-investment at our consolidated Sequoia entities and at Redwood, proceeds from sales of loans, and principal payments from, and proceeds from net sales of, real estate securities. Although we generally intend to hold our investment securities as long-term investments, we may sell certain of these securities in order to manage our interest rate risk and liquidity needs, to meet other operating objectives, and to adapt to market conditions. We cannot predict the timing and impact of future sales of investment securities, if any.

Because many of our investment securities are financed through repurchase agreements, a significant portion of the proceeds from any sales or principal payments of our investment securities would generally be used to repay balances under these financing sources. Similarly, all or a significant portion of cash flows from principal payments of loans at consolidated Sequoia entities would generally be used to repay ABS issued by those entities.

In addition, during the nine months ended September 30, 2016, we had transfers of residential loans with a carrying value of \$878 million from held-for-sale to held-for-investment, transfers of commercial loans with a carrying value of \$359 million from held-for-investment to held-for-sale, and we retained MSRs with a carrying value of \$8 million from the sale of residential loans. These non-cash transactions were not included in cash flows from investing activities.

### Cash Flows from Financing Activities

During the nine months ended September 30, 2016, our net cash used in financing activities was \$392 million. This primarily resulted from \$600 million of net repayments of short-term debt, \$209 million of repayments of ABS issued, and \$28 million of cash utilized for stock repurchases. These payments were offset by \$519 million of net borrowings from the FHLBC that were used to finance residential loans held-for-investment.

In December 2015, our Board of Directors announced its intention to pay a regular dividend of \$0.28 per share per quarter in 2016. During the nine months ended September 30, 2016, we paid \$66 million of cash dividends on our common stock, representing a dividend of \$0.84 per share. In November 2016, the Board of Directors declared a regular dividend of \$0.28 per share for the fourth quarter of 2016, which is payable on December 29, 2016 to shareholders of record on December 15, 2016.

In accordance with the terms of outstanding deferred stock units, which are stock-based compensation awards, each time we declare and pay a dividend on our common stock, we are required to make a dividend equivalent payment in that same per share amount on each outstanding deferred stock unit.

### Short-Term Debt

In the ordinary course of our business, we use recourse debt through several different types of borrowing facilities and use cash borrowings under these facilities to, among other things, fund the acquisition of residential loans (including those we acquire and originate in anticipation of securitization), finance investments in securities and other investments, and otherwise fund our business and operations.

At September 30, 2016, we had four short-term residential loan warehouse facilities with a total outstanding debt balance of \$838 million (secured by residential loans with an aggregate fair value of \$941 million) and a total uncommitted borrowing limit of \$1.33 billion. At September 30, 2016, we also had one short-term commercial loan warehouse facilities with no outstanding balances. In addition, at September 30, 2016, we had an aggregate outstanding short-term debt balance of \$280 million under seven securities repurchase facilities, which were secured by securities with a fair market value of \$336 million. We also had a secured line of credit with no outstanding debt balance and a total borrowing limit of \$10 million (secured by securities with a fair market value of \$10 million) at September 30, 2016.

At September 30, 2016, we had \$1.12 billion of short-term debt outstanding. During the first nine months of 2016, the highest balance of our short-term debt outstanding was \$1.87 billion.

### Long-Term Debt

#### FHLBC Borrowings

In July 2014, our FHLB-member subsidiary entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. At September 30, 2016, under this agreement, our subsidiary could incur borrowings up to \$2.00 billion, also referred to as “advances,” from the FHLBC secured by eligible collateral, including, but not limited to residential mortgage loans. During the nine months ended September 30, 2016, our FHLB-member subsidiary borrowed an additional \$519 million under this agreement. Under a final rule published by the Federal Housing Finance Agency in January 2016, our FHLB-member subsidiary will remain an FHLB member through the five-year transition period for captive insurance companies. Our FHLB-member subsidiary's existing \$2.00 billion of FHLB debt, which matures beyond this transition period, is permitted to remain outstanding until stated maturity. As residential loans pledged as collateral for this debt pay down, we are permitted to pledge additional loans or other eligible assets to collateralize this debt; however, we do not expect to be able to increase our subsidiary's FHLB debt above the existing \$2.00 billion maximum.

At September 30, 2016, \$2.00 billion of advances were outstanding under this agreement, which were classified as long-term debt, with a weighted average interest rate of 0.57% and a weighted average maturity of nine years. At September 30, 2016, accrued interest payable on these borrowings was \$2 million. Advances under this agreement are charged interest based on a specified margin over the FHLBC's 13-week discount note rate, which resets every 13 weeks. Our total advances under this agreement were secured by residential mortgage loans with a fair value of \$2.27 billion at September 30, 2016. This agreement also requires our subsidiary to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of outstanding advances. At September 30, 2016, our subsidiary held \$43 million of FHLBC stock that is included in other assets in our consolidated balance sheets.

#### Convertible Notes

In November 2014, one of our taxable subsidiaries issued \$205 million principal amount of 5.625% exchangeable senior notes due 2019. After deducting the underwriting discount and issuance costs, we received approximately \$198 million of net proceeds. Including amortization of deferred securities issuance costs, the weighted average interest expense yield on these exchangeable notes was approximately 6.6% per annum. During the nine months ended September 30, 2016, we repurchased \$4 million par value of these notes at a discount and recorded a gain on extinguishment of debt of \$0.3 million in Realized gains, net on our consolidated statements of income. At September 30, 2016, the outstanding principal amount of these notes was \$201 million. At September 30, 2016, the accrued interest payable balance on this debt was \$5 million.

In March 2013, we issued \$288 million principal amount of 4.625% convertible senior notes due 2018. After deducting the underwriting discount and issuance costs, we received approximately \$279 million of net proceeds. Including amortization of deferred securities issuance costs, the weighted average interest expense yield on these

convertible notes was approximately 5.4% per annum. At September 30, 2016, the accrued interest payable balance on this debt was \$7 million.

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#### Trust Preferred Securities and Subordinated Notes

At September 30, 2016, we had trust preferred securities and subordinated notes outstanding of \$100 million and \$40 million, respectively, issued by us in 2006 and 2007. This debt requires quarterly interest payments at a floating rate equal to three-month LIBOR plus 2.25% until the debt is extinguished. Prior to 2014, we entered into interest rate swaps with aggregate notional values totaling \$140 million to hedge the variability in this long-term debt interest expense. Including hedging costs and amortization of deferred securities issuance costs, the weighted average interest expense yield on our trust preferred securities and subordinated notes is approximately 6.9% per annum. These swaps are accounted for as cash flow hedges with all interest recorded as a component of net interest income and other valuation changes recorded as a component of equity.

#### Commercial Secured Borrowings

Prior to the third quarter of 2016, we had approximately \$63 million of commercial secured borrowings that resulted from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. During the third quarter of 2016, we sold our retained junior portions of the loans we had originally bifurcated from these senior loans and derecognized the secured borrowing liability and the associated senior portion of the loan from our consolidated balance sheet.

#### Asset-Backed Securities

At September 30, 2016, there were \$943 million (principal balance) of loans owned at consolidated Sequoia securitization entities, which were funded with \$936 million (principal balance) of ABS issued at these entities. The loans and ABS issued from these entities are reported at estimated fair value. See the subsection titled "Results of Consolidated Sequoia Entities" in the Results of Operations section of this MD&A for additional details on these entities. During the second quarter of 2016, the debt of the Commercial Securitization was repaid.

#### Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities

As described above under the heading "Results of Operations," in the ordinary course of our business, we use debt financing obtained through several different types of borrowing facilities to, among other things, finance the acquisition of residential mortgage loans (including those we acquire in anticipation of sale or securitization), and finance investments in securities and other investments. We may also use short- and long-term borrowings to fund other aspects of our business and operations, including the repurchase of shares of our common stock. Debt incurred under these facilities is generally either the direct obligation of Redwood Trust, Inc., or the direct obligation of subsidiaries of Redwood Trust, Inc. and guaranteed by Redwood Trust, Inc. Risks relating to debt incurred under these facilities are described in Part I, Item 2 of our Annual Report on Form 10-K for the year ended December 31, 2015, under the caption "Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities."

Our sources of debt financing include short-term secured borrowings under residential loan warehouse facilities, short-term securities repurchase facilities, a \$10 million committed line of short-term secured credit from a bank, and secured borrowings by our wholly-owned subsidiary, RWT Financial, LLC, under its borrowing facility with the FHLBC.

Aggregate borrowing limits are stated under certain of these facilities, and certain other facilities have no stated borrowing limit, but each of the facilities (with the exception of the \$10 million committed line of short-term secured credit) is uncommitted, which means that any request we make to borrow funds under these uncommitted facilities may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under these facilities. In general, financing under these facilities is obtained by transferring or pledging mortgage loans or securities to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred or pledged assets). While transferred or pledged assets are financed under a facility, to the extent the market value of the assets declines, we are generally required to either immediately reacquire the assets or meet a margin requirement to transfer or pledge additional assets or cash in an amount at least equal to the decline in value. Margin call provisions under these facilities are further described in Part I, Item 2 of our Annual Report on Form 10-K for the year ended December 31, 2015 under the caption “Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities - Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing.” Financial covenants included in these facilities are further described Part I, Item 2 of our Annual Report on Form 10-K for the year ended December 31, 2015 under the caption “Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities - Financial Covenants Associated with Short-Term Debt and Other Debt Financing.” Financial covenants included in these facilities are further described Part I, Item 2 of our Annual Report on Form 10-K for the year ended December 31, 2015 under the caption “Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities - Financial Covenants Associated with Short-Term Debt and Other Debt Financing.”

Because these warehouse facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015 under the heading “Risk Factors,” and in Part II, Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2015 under the heading “Market Risks.” In addition, with respect to loans and securities that at any given time are already being financed through these facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015 under the heading “Risk Factors,” and in Part II, Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2015 under the heading “Market Risks,” if and when those loans or securities become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the applicable facility. Additionally, our access to financing under the borrowing facility with the FHLBC is subject to the risks described under the heading “Risk Factors - Recently Adopted Federal regulations may limit, eliminate, or reduce the attractiveness of our subsidiary’s ability to use borrowings from the Federal Home Loan Bank of Chicago to finance the mortgage loans and securities it holds and acquires, which could negatively impact our business and operating results” in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015.

At September 30, 2016, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with the financial covenants associated with our short-term debt and other debt financing facilities. In particular, with respect to: (i) financial covenants that require us to maintain a minimum dollar amount of stockholders’ equity or tangible net worth, at September 30, 2016 our level of stockholders’ equity and tangible net worth resulted in our being in compliance with these covenants by more than \$200 million; and (ii) financial covenants that require us to maintain recourse indebtedness below a specified ratio, at September 30, 2016 our level of recourse indebtedness resulted in our being in compliance with these covenants at a level such that we could incur at least \$600 million in additional recourse indebtedness.

## OFF BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

## Off Balance Sheet Arrangements

We do not have any material off balance sheet arrangements.

## Contractual Obligations

The following table presents our contractual obligations and commitments at September 30, 2016, as well as the obligations of the securitization entities that we sponsor and consolidate for financial reporting purposes.

Table 37 – Contractual Obligations and Commitments

| September 30, 2016<br><br>(In Millions)  | Payments Due or Commitment Expiration<br>by Period |                 |                 |                  | Total          |
|--|--|-----------------|-----------------|------------------|----------------|
|  | Less<br>Than<br>1 Year                             | 1 to 3<br>Years | 3 to 5<br>Years | After 5<br>Years |                |
| Obligations of Redwood   |  |                 |                 |                  |                |
| Short-term debt  | \$1,117  | \$—             | \$—             | \$—              | \$1,117        |
| Convertible notes  | —  | 288             | 201             | —                | 489            |
| Anticipated interest payments on convertible notes                                 | 25   | 36              | 6               | —                | 67             |
| FHLBC borrowings   | —  | —               | —               | 2,000            | 2,000          |
| Anticipated interest payments on FHLBC borrowings                                  | 20   | 46              | 55              | 133              | 254            |
| Other long-term debt   | —  | —               | —               | 138              | 138            |
| Anticipated interest payments on other long-term debt <sup>(1)</sup>               | 9  | 19              | 19              | 145              | 192            |
| Accrued interest payable   | 15   | —               | —               | —                | 15             |
| Operating leases   | 2  | 2               | 1               | —                | 5              |
| <b>Total Redwood Obligations and Commitments</b>                                   | <b>\$1,188</b>                                     | <b>\$391</b>    | <b>\$282</b>    | <b>\$2,416</b>   | <b>\$4,277</b> |
| Obligations of Consolidated Entities for Financial Reporting Purposes              |  |                 |                 |                  |                |
| Consolidated ABS <sup>(2)</sup>  | \$—  | \$—             | \$—             | \$936            | \$936          |
| Anticipated interest payments on ABS <sup>(3)</sup>                                | 14   | 28              | 28              | 87               | 157            |
| Accrued interest payable   | 1  | —               | —               | —                | 1              |
| <b>Total Obligations of Entities Consolidated for Financial Reporting Purposes</b> | <b>15</b>  | <b>28</b>       | <b>28</b>       | <b>1,023</b>     | <b>1,094</b>   |
| <b>Total Consolidated Obligations and Commitments</b>                              | <b>\$1,203</b>                                     | <b>\$419</b>    | <b>\$310</b>    | <b>\$3,439</b>   | <b>\$5,371</b> |

(1) Includes anticipated interest payments related to hedges.

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

(3) The anticipated interest payments on consolidated ABS issued is calculated based on the contractual maturity of the ABS and therefore assumes no prepayments of the principal outstanding at September 30, 2016.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. A discussion of critical accounting policies and the possible effects of changes in estimates on our consolidated financial statements is included in Note 3 — Summary of Significant Accounting Policies included in Part I, Item 1 of this Quarterly Report on Form 10-Q and in Part I, Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2015. Management discusses the ongoing development and selection of these critical accounting policies with the audit committee of the board of directors.

We expect quarter-to-quarter GAAP earnings volatility from our business activities. This volatility can occur for a variety of reasons, including the timing and amount of purchases, sales, calls, and repayment of consolidated assets, changes in the fair values of consolidated assets and liabilities, increases or decreases in earnings from mortgage banking activities, the recording of provision for or benefit from taxes, and certain non-recurring events. In addition, the amount or timing of our reported earnings may be impacted by technical accounting issues and estimates. Our critical accounting policies and the possible effects of changes in estimates on our consolidated financial statements are included in the "Critical Accounting Policies and Estimates" section of Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015.

### Market Risks

We seek to manage risks inherent in our business — including but not limited to credit risk, interest rate risk, prepayment risk, liquidity risk, and fair value risk — in a prudent manner designed to enhance our earnings and dividends and preserve our capital. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, and to maintain capital levels consistent with these risks. Information concerning the risks we are managing, how these risks are changing over time, and potential GAAP earnings and taxable income volatility we may experience as a result of these risks is discussed in Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

### Other Risks

In addition to the market and other risks described above, our business and results of operations are subject to a variety of types of risks and uncertainties, including, among other things, those described under the caption "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

## NEW ACCOUNTING STANDARDS

A discussion of new accounting standards and the possible effects of these standards on our consolidated financial statements is included in Note 3 — Summary of Significant Accounting Policies included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Information concerning market risk is incorporated herein by reference to Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015, as supplemented by the information under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Market Risks" within Item 2 above. Other than the developments described thereunder, including changes in the fair values of our assets, there have been no other material changes in our quantitative or qualitative exposure to market risk since December 31, 2015.



#### Item 4. Controls and Procedures

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

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

There have been no changes in our internal control over financial reporting during the third quarter of 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the “FHLB-Seattle”) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (“SRF”), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the “FHLB-Seattle Defendants”) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Seattle Certificate”) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the “2005-4 RMBS”) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys’ fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, at September 30, 2016, the FHLB-Seattle has received approximately \$122 million of principal and \$11 million of interest payments in respect of the Seattle Certificate. At September 30, 2016, the Seattle Certificate had a remaining outstanding principal amount of approximately \$12 million. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. At the time the Seattle Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle’s claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (“Schwab”) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the “Schwab Defendants”) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. Schwab alleged only a claim for negligent misrepresentation under California state law against SRF and sought unspecified damages and attorneys’ fees and costs from SRF. Schwab claims that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Schwab Certificate”) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. On November 14, 2014, Schwab voluntarily dismissed with prejudice its negligent misrepresentation claim, which resulted in the dismissal with prejudice of SRF from the action. The Schwab Certificate was issued with an original principal amount of approximately \$15 million, and, at September 30, 2016, approximately \$14 million of principal and \$1 million of interest payments have been made in respect of the Schwab Certificate. At September 30, 2016, the Schwab Certificate had a remaining outstanding principal amount of approximately \$1 million. At the time the Schwab Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named and remain as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

Through certain of our wholly-owned subsidiaries, we have in the past engaged in, and expect to continue to engage in, activities relating to the acquisition and securitization of residential mortgage loans. In addition, certain of our wholly-owned subsidiaries have in the past engaged in activities relating to the acquisition and securitization of debt obligations and other assets through the issuance of collateralized debt obligations (commonly referred to as CDO transactions). Because of this involvement in the securitization and CDO businesses, we could become the subject of litigation relating to these businesses, including additional litigation of the type described above, and we could also become the subject of governmental investigations, enforcement actions, or lawsuits, and governmental authorities could allege that we violated applicable law or regulation in the conduct of our business. As an example, we recently became aware of a complaint filed by the State of California on April 1, 2016 against Morgan Stanley & Co. and certain of its affiliates alleging, among other things, that there were misleading statements contained in offering materials for 28 different mortgage pass-through certificates purchased by various California investors, including various California public pension systems, from Morgan Stanley and alleging that Morgan Stanley made false or fraudulent claims in connection with the sale of those certificates. Of the 28 mortgage pass-through certificates that are the subject of the complaint, two are Sequoia mortgage pass-through certificates issued in 2004 and two are Sequoia mortgage pass-through certificates issued in 2007, with respect to each of which certificates our wholly-owned subsidiary, RWT Holdings, Inc., was the sponsor and our wholly-owned subsidiary, Sequoia Residential Funding, Inc., was the depositor. At the time these four Sequoia mortgage pass-through certificates were issued, Sequoia Residential Funding, Inc. and Redwood Trust agreed to indemnify the underwriters of these certificates for certain losses and expenses they might incur as a result of claims made against them relating to these certificates, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At September 30, 2016, the aggregate amount of loss contingency reserves established in respect of the FHLB-Seattle and Schwab litigation matters described above was \$2 million. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

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

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

relating to these litigation matters that could increase our potential losses.

Item 1A. Risk Factors

Our risk factors are discussed under Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015.

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## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the three months ended September 30, 2016, we did not sell any equity securities that were not registered under the Securities Act of 1933, as amended. In August 2015, our Board of Directors authorized the repurchase of up to \$100 million of our common stock. During the nine months ended September 30, 2016, we repurchased 839,130 common shares for \$11 million, utilizing the remaining availability under this authorization.

In February 2016, our Board of Directors authorized the repurchase of up to \$100 million of our common stock and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. This authorization replaced all previous share repurchase plans and has no expiration date. This repurchase authorization does not obligate us to acquire any specific number of shares or securities. Under this authorization, shares or securities may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. Under this authorization, during the three and nine months ended September 30, 2016, we repurchased 259,005 shares for \$3 million and 1,078,743 shares for \$14 million, respectively. At September 30, 2016, approximately \$86 million of this current authorization remained available for the repurchase of shares of our common stock.

The following table contains information on the shares of our common stock that we purchased or otherwise acquired during the three months ended September 30, 2016.

| (In Thousands, except per Share Data)  | Total<br>Number of<br>Shares<br>Purchased<br>or<br>Acquired | Average<br>Price<br>per<br>Share<br>Paid | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number (or<br>approximate<br>dollar value)<br>of Shares<br>that May Yet<br>be Purchased<br>under the<br>Plans or<br>Programs |
|--|---|--|--|---|
| July 1, 2016 - July 31, 2016           | —   | \$ 13.81                                 | —  | \$ —  |
| August 1, 2016 - August 31, 2016       | —   | \$ —                                     | —  | \$ —  |
| September 1, 2016 - September 30, 2016 | 259   | \$ 13.45                                 | 259  | \$ 86,450   |
| Total                                  | 259   | \$ 13.47                                 | 259  | \$ 86,450   |

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Not Applicable

## Item 5. Other Information

None.

Item 6. Exhibits

| Exhibit Number | Exhibit  |
|----------------|--|
| 3.1            | Articles of Amendment and Restatement of the Registrant, effective July 6, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1, filed on August 6, 2008)                      |
| 3.1.1          | Articles Supplementary of the Registrant, effective August 10, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.1, filed on August 6, 2008)                                |
| 3.1.2          | Articles Supplementary of the Registrant, effective August 11, 1995 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.2, filed on August 6, 2008)                                |
| 3.1.3          | Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008)                                 |
| 3.1.4          | Certificate of Amendment of the Registrant, effective June 30, 1998 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.4, filed on August 6, 2008)                                |
| 3.1.5          | Articles Supplementary of the Registrant, effective April 7, 2003 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.5, filed on August 6, 2008)                                  |
| 3.1.6          | Articles of Amendment of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008)                                   |
| 3.1.7          | Articles of Amendment of the Registrant, effective May 19, 2009 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009)   |
| 3.1.8          | Articles of Amendment of the Registrant, effective May 24, 2011 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 20, 2011)   |
| 3.1.9          | Articles of Amendment of the Registrant, effective May 18, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2012)   |
| 3.1.10         | Articles of Amendment of the Registrant, effective May 16, 2013 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2013)   |
| 3.2.1          | Amended and Restated Bylaws of the Registrant, as adopted on March 5, 2008 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008)                              |
| 3.2.2          | First Amendment to Amended and Restated Bylaws of the Registrant, as adopted on May 17, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.2, filed on May 21, 2012)              |
| 31.1           | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2           | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1           | Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
| 32.2           | Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
|                | Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2016, is filed in XBRL-formatted interactive data files: |
| 101            | (i) Consolidated Balance Sheets at September 30, 2016 and December 31, 2015;   |
|                | (ii) Consolidated Statements of Income for the three and nine months ended September 30, 2016 and 2015;  |
|                | (iii) Statements of Consolidated Comprehensive Income for the three and nine months ended September 30, 2016 and 2015;   |
|                | (iv) Consolidated Statements of Changes in Stockholder's Equity for the nine months ended September 30, 2016 and 2015;   |
|                | (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015; and   |
|                | (vi) Notes to Consolidated Financial Statements.   |



SIGNATURES

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

REDWOOD TRUST, INC.

Date: November 7, 2016 By: /s/ Martin S. Hughes  
Martin S. Hughes  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 7, 2016 By: /s/ Christopher J. Abate  
Christopher J. Abate  
President and Chief Financial Officer  
(Principal Financial Officer)

Date: November 7, 2016 By: /s/ Collin L. Cochrane  
Collin L. Cochrane  
Controller and Managing Director  
(Principal Accounting Officer)



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