REDWOOD TRUST INC
Form 10-Q
November 06, 2015

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: September 30, 2015

OR

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

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

REDWOOD TRUST, INC.
(Exact Name of Registrant as Specified in Its Charter)

Maryland	68-0329422
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
One Belvedere Place, Suite 300 Mill Valley, California	94941
(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 x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer x Accelerated filer o Non-accelerated filer o Smaller reporting company o

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

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

Common Stock, $0.01 par value per share	82,124,371 shares outstanding as of November 5, 2015

REDWOOD TRUST, INC.
2015 FORM 10-Q REPORT
TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)
(Unaudited)

	September 30, 2015	December 31, 2014
ASSETS [1]		
Residential loans, held-for-sale, at fair value	$1,506,151	$1,342,519
Residential loans, held-for-investment, at fair value [2]	2,530,523	2,056,054
Commercial loans, held-for-sale, at fair value	80,756	166,234
Commercial loans, held-for-investment (includes $70,096 and $71,262 at fair value)	387,401	400,693
Real estate securities, at fair value	1,085,224	1,379,230
Mortgage servicing rights, at fair value	162,726	139,293
Cash and cash equivalents	235,362	269,730
Total earning assets	5,988,143	5,753,753
Restricted cash	8,361	628
Accrued interest receivable	20,223	18,222
Derivative assets	38,623	16,417
Deferred securities issuance costs	12,080	16,050
Other assets	201,596	113,896
Total Assets	$6,269,026	$5,918,966
LIABILITIES AND EQUITY [1]		
Liabilities		
Short-term debt	$1,872,793	$1,793,825
Accrued interest payable	14,738	8,503
Derivative liabilities	88,044	58,331
Accrued expenses and other liabilities	75,968	52,244
Deferred tax liability	10,236	10,236
Asset-backed securities issued (includes $1,105,588 and $0 at fair value) [2]	1,178,795	1,545,119
Long-term debt (includes $65,578 and $66,707 at fair value)	1,821,877	1,194,567
Total liabilities	5,062,451	4,662,825
Equity		
Common stock, par value $0.01 per share, 180,000,000 shares authorized; 82,124,927 and 83,443,141 issued and outstanding	821	834
Additional paid-in capital	1,746,775	1,774,030
Accumulated other comprehensive income	119,721	140,688
Cumulative earnings	977,624	906,867
Cumulative distributions to stockholders	(1,638,366)	(1,566,278)
Total equity	1,206,575	1,256,141
Total Liabilities and Equity	$6,269,026	$5,918,966

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(1) 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 recourse to Redwood Trust, Inc. or its affiliates. At September 30, 2015 and December 31, 2014, assets of consolidated VIEs totaled $1,539,350 and $1,900,208, respectively. At September 30, 2015 and December 31, 2014, liabilities of consolidated VIEs totaled $1,179,884 and $1,546,490, respectively. See Note 4 for further discussion.

(2)

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data)	Three Months Ended September 30,		Nine Months Ended September 30,	
(Unaudited)	2015	2014	2015	2014
Interest Income				
Residential loans	$29,472	$19,280	$80,289	$45,539
Commercial loans	11,191	12,603	34,784	34,204
Real estate securities	22,749	31,461	75,363	97,062
Other interest income	72	7	167	15
Total interest income	63,484	63,351	190,603	176,820
Interest Expense				
Short-term debt	(7,627)	(8,441)	(21,378)	(17,409)
Asset-backed securities issued	(5,190)	(7,838)	(17,037)	(24,462)
Long-term debt	(11,058)	(7,071)	(32,429)	(21,689)
Total interest expense	(23,875)	(23,350)	(70,844)	(63,560)
Net Interest Income	39,609	40,001	119,759	113,260
Reversal of provision for loan losses	60	1,596	115	629
Net Interest Income After Provision	39,669	41,597	119,874	113,889
Non-interest Income				
Mortgage banking and investment activities, net	(12,836)	14,166	(6,399)	9,984
Mortgage servicing rights income (loss), net	3,549	5,821	(6,545)	4,650
Other income	327	1,600	2,435	1,600
Realized gains, net	5,548	8,532	16,170	10,687
Total non-interest income (loss)	(3,412)	30,119	5,661	26,921
Operating expenses	(24,497)	(21,406)	(74,778)	(63,660)
Net income before provision for income taxes	11,760	50,310	50,757	77,150
Benefit from (provision for) income taxes	7,404	(5,213)	10,272	(3,703)
Net Income	$19,164	$45,097	$61,029	$73,447
Basic earnings per common share	$0.22	$0.53	$0.71	$0.87
Diluted earnings per common share	$0.22	$0.50	$0.69	$0.84
Regular dividends declared per common share	$0.28	$0.28	$0.84	$0.84
Basic weighted average shares outstanding	83,787,533	83,017,534	83,696,461	82,722,079
Diluted weighted average shares outstanding	85,074,704	96,956,232	85,338,996	85,031,130

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 Ended September 30,		Nine Months Ended September 30,	
(Unaudited)	2015	2014	2015	2014
Net Income	$19,164	$45,097	$61,029	$73,447
Other comprehensive income (loss):				
Net unrealized (loss) gain on available-for-sale securities	(5,673)	1,849	(5,701)	35,078
Reclassification of unrealized gain on available-for-sale securities to net income	(3,270)	(6,409)	(10,320)	(6,750)
Net unrealized loss on interest rate agreements	(12,049)	(3,258)	(5,023)	(17,454)
Reclassification of unrealized loss on interest rate agreements to net income	19	32	77	131
Total other comprehensive income (loss)	(20,973)	(7,786)	(20,967)	11,005
Total Comprehensive Income (Loss)	$(1,809)	$37,311	$40,062	$84,452

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

4

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

For the Nine Months Ended September 30, 2015

(In Thousands, Except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2014	83,443,141	$834	$1,774,030	$140,688	$906,867	$(1,566,278)	$1,256,141
Cumulative effect adjustment - adoption of ASU 2014-13 [(1)]	—	—	—	—	9,728	—	9,728
January 1, 2015	83,443,141	834	1,774,030	140,688	916,595	(1,566,278)	1,265,869
Net income	—	—	—	—	61,029	—	61,029
Other comprehensive loss	—	—	—	(20,967)	—	—	(20,967)
Dividend reinvestment & stock purchase plans	418,508	4	6,830	—	—	—	6,834
Employee stock purchase and incentive plans	714,801	7	(7,735)	—	—	—	(7,728)
Non-cash equity award compensation	—	—	9,002	—	—	—	9,002
Share repurchases	(2,451,523)	(24)	(35,352)	—	—	—	(35,376)
Common dividends 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

For the Nine Months Ended September 30, 2014

(In Thousands, Except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2013	82,504,801	$825	$1,760,899	$148,766	$806,298	$(1,471,005)	$1,245,783
Net income	—	—	—	—	73,447	—	73,447
Other comprehensive income	—	—	—	11,005	—	—	11,005
Dividend reinvestment & stock purchase plans	336,810	4	6,051	—	—	—	6,055
Employee stock purchase and incentive plans	442,781	4	(7,272)	—	—	—	(7,268)

Non-cash equity award compensation	—	—	8,934	—	—	—	8,934
Common dividends declared	—	—	—	—	—	(71,278)	(71,278)
September 30, 2014	83,284,392	$833	$1,768,612	$159,771	$879,745	$(1,542,283)	$1,266,678

(1) On January 1, 2015, we adopted ASU 2014-13. See Note 3 for further discussion.

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

5

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

(In Thousands) (Unaudited)	Nine Months Ended September 30,	
	2015	2014
Cash Flows From Operating Activities:		
Net income	$61,029	$73,447
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(26,244)	(26,248)
Depreciation and amortization of non-financial assets	510	369
Purchases of held-for-sale loans	(8,794,939)	(6,844,403)
Proceeds from sales of held-for-sale loans	7,741,024	5,328,901
Principal payments on held-for-sale loans	46,952	19,648
Net settlements of derivatives	(47,002)	(22,776)
Provision for loan losses	(115)	(629)
Non-cash equity award compensation expense	9,002	8,934
Market valuation adjustments	40,546	(1,787)
Realized gains, net	(16,170)	(10,687)
Net change in:		
Accrued interest receivable and other assets	(90,605)	(57,806)
Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities	26,094	(266)
Net cash used in operating activities	(1,049,918)	(1,533,303)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(22,219)	(65,584)
Principal payments on loans held-for-investment	359,714	267,425
Purchases of real estate securities	(66,601)	(132,393)
Proceeds from sales of real estate securities	309,101	457,131
Principal payments on real estate securities	103,664	144,598
Purchase of mortgage servicing rights	(23,315)	(41,834)
Proceeds from sales of mortgage servicing rights	17,235	—
Net change in restricted cash	(7,733)	(57)
Net cash provided by investing activities	669,846	629,286
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	6,213,505	5,615,317
Repayments on short-term debt	(6,160,226)	(4,643,308)
Repayments on asset-backed securities issued	(256,614)	(286,248)
Deferred securities issuance costs	(33)	—
Proceeds from issuance of long-term debt	1,156,396	272,937
Repayments on long-term debt	(502,268)	(685)
Net settlements of derivatives	(32)	(2,507)
Net proceeds from issuance of common stock	7,198	3,840
Net payments on repurchase of common stock	(32,042)	—
Taxes paid on equity award distributions	(8,092)	(7,635)
Dividends paid	(72,088)	(71,278)
Net cash provided by financing activities	345,704	880,433
Net decrease in cash and cash equivalents	(34,368)	(23,584)
Cash and cash equivalents at beginning of period	269,730	173,201
Cash and cash equivalents at end of period	$235,362	$149,617
Supplemental Cash Flow Information:		

Cash paid during the period for:		
Interest	$57,998	$57,047
Taxes	55	1,399
Supplemental Noncash Information:		
Real estate securities retained from loan securitizations	$39,698	$126,009
Retention of mortgage servicing rights from loan securitizations and sales	52,297	30,962
Transfers from loans held-for-sale to loans held-for-investment	964,013	278,913
Transfers from loans held-for-investment to loans held-for-sale	66,918	—
Transfers from residential loans to real estate owned	5,740	4,753

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

Note 1. Organization

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

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), beginning with its taxable year ended December 31, 1994. To qualify as a REIT, Redwood Trust, Inc. must distribute at least 90% of its annual REIT taxable income to shareholders (not including taxable income retained in its taxable subsidiaries) within the time frame set forth in the Internal Revenue Code and also meet certain other requirements related to assets, income, and stock ownership. We generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as “the REIT” or “our REIT.” We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as “our operating subsidiaries” or “our taxable REIT subsidiaries” or “TRS.” We generally intend to distribute as dividends at least 90% of the taxable income we generate at our REIT.

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2015 and December 31, 2014, and for the three and nine months ended September 30, 2015 and 2014. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with consolidated financial statements and notes thereto included in the company's Annual Report on Form 10-K for the year ended December 31, 2014. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at September 30, 2015 and results of operations for all periods presented have been made. The results of operations for the three and nine months ended September 30, 2015 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 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, beginning in the second quarter of 2015, we combined our "Mortgage banking activities" and "Other market valuation adjustments" line items on our consolidated statements of income into a single line, now called "Mortgage banking and investment activities, net." As we currently manage our market interest rate risk on the remainder of our assets (excluding MSRs) on a net basis, we believe that combining these two line items will better reflect the net effect of our hedging activities on the assets associated with derivatives that are marked-to-market each quarter. We have conformed the presentation of prior periods related to this change for consistency of comparison.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)
Note 2. Basis of Presentation - (continued)

Principles of Consolidation
In accordance with GAAP, we determine whether we must consolidate transferred financial assets and variable interest entities (“VIEs”) for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during 2011 (“Residential Resecuritization”), and an entity formed in connection with a commercial securitization we engaged in during 2012 (“Commercial Securitization”). Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. For financial reporting purposes, the underlying loans and securities owned at the consolidated Sequoia entities, the Residential Resecuritization entity, and the Commercial Securitization entity are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The asset-backed securities (“ABS”) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned at these entities and interest expense on the ABS issued by these entities as well as other income and expenses associated with these entities' activities.
See Note 4 for further discussion on principles of consolidation.
Use of Estimates
The preparation of financial statements requires us to make a number of significant estimates. These include estimates of fair value of certain assets and liabilities, amounts and timing of credit losses, prepayment rates, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported periods. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences could be material.
Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies
Included in Note 3 to the Consolidated Financial Statements of our 2014 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company’s consolidated financial condition and results of operations for the three and nine months ended September 30, 2015.
Recent Accounting Pronouncements
Adoption of ASU 2014-13
In November 2014, the FASB issued ASU 2014-13, “Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity” ("ASU 2014-13"). This update provides a measurement alternative to companies that consolidate collateralized financing entities ("CFEs"). Under the new guidance, companies can measure both the financial assets and financial liabilities of a CFE using the more observable of the fair value of the financial assets or fair value of the financial liabilities. This guidance is effective in the first quarter 2016 with early adoption permitted at the beginning of an annual period. The guidance can be applied either retrospectively to all relevant prior periods or by a modified retrospective approach with a cumulative-effect adjustment to equity as of the beginning of the annual period of adoption.
On January 1, 2015, we elected to early adopt ASU 2014-13, as we determined this measurement alternative more accurately reflects our economic interests in, and financial results from, certain consolidated financing entities. We

adopted the measurement alternative under this standard only for our consolidated Sequoia entities, which qualify under the standard as CFEs. We did not elect the measurement alternative for our Residential Resecuritization or our Commercial Resecuritization, and will continue to account for the assets and liabilities in these CFEs in accordance with existing accounting guidance.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

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

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

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

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

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

Table 3.1 – Impact of Adoption of ASU 2014-13 on Balance Sheet(1)

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

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

Other Recent Accounting Pronouncements
In April 2015, the FASB issued ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs." This new guidance requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount. This new guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The new guidance is required to be applied on a retrospective basis. We plan to adopt this new guidance by the required date and will reclassify our deferred securities issuance costs that we currently present on the face of our consolidated balance sheets and present them as debt discounts.
In February 2015, the FASB issued ASU 2015-02, "Consolidation (Topic 810) - Amendments to the Consolidation Analysis." This new guidance provides a new scope exception for certain money market funds, makes targeted amendments to the current consolidation guidance, and ends the deferral granted to investment companies from applying the VIE guidance. This new guidance is effective for annual periods beginning after December 15, 2015. Early adoption is allowed, including in any interim period. We are evaluating the impact of adopting this new standard.
In June 2014, the FASB issued ASU 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures." This new guidance amends the accounting guidance for "repo-to-maturity" transactions and repurchase agreements executed as repurchase financings. In addition, the new standard requires a transferor to disclose more information about certain transactions, including those in which it retains substantially all of the exposure to the economic returns of the underlying transferred asset over the transaction's term. This new guidance is effective in the first interim reporting period beginning after December 15, 2014. However, for repurchase and securities lending transactions reported as secured borrowings, the new standard's enhanced disclosures are effective for annual periods beginning after December 15, 2014 and interim periods beginning after March 15, 2015. We adopted the new guidance, as required, in the first quarter of 2015 and adopted the disclosure requirements in the second quarter of 2015, as required, which are included in Note 12 of these notes to our consolidated financial statements. The adoption in the first quarter of 2015 did not have a material impact on our financial statements, as we did not have repo-to-maturity transactions outstanding.
In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers." The 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. We are evaluating the impact the update will have on our consolidated financial statements.
In January 2014, the FASB issued ASU 2014-04, "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure." This update to the receivable guidance clarifies when a creditor is considered to have received physical possession of residential real estate resulting from an in substance repossession or foreclosure. In addition, the amendments require disclosure of both: (i) the amount of foreclosed residential real estate property held by the creditor; and (ii) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The update requires the guidance to be applied using either a modified retrospective transition method or a prospective transition method for interim and annual periods beginning after December 15, 2014, with early adoption permitted. We adopted this standard in the first quarter of 2015, as

required, and it did not have a material impact on our financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

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

Balance Sheet Netting
Certain of our derivatives and short-term debt are subject to master netting arrangements or similar agreements. Under GAAP, in certain circumstances we may elect to present certain financial assets, liabilities and related collateral subject to master netting arrangements in a net position on our consolidated balance sheets. However, we do not report any of these financial assets or liabilities on a net basis, and instead present them on a gross basis on our consolidated balance sheets.
The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at September 30, 2015 and December 31, 2014.
Table 3.2 – Offsetting of Financial Assets, Liabilities, and Collateral

September 30, 2015 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet (1)		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
Assets (2)						
Interest rate agreements	$16,788	$—	$16,788	$(9,932)	$(6,856)	$—
Credit default index swaps	2,792	—	2,792	—	—	2,792
TBAs	8,910	—	8,910	(8,659)	—	251
Total Assets	$28,490	$—	$28,490	$(18,591)	$(6,856)	$3,043
Liabilities (2)						
Interest rate agreements	$(72,415)	$—	$(72,415)	$9,932	$59,933	$(2,550)
TBAs	(14,994)	—	(14,994)	8,659	3,868	(2,467)
Futures	(188)	—	(188)	—	188	—
Loan warehouse debt	(1,271,610)	—	(1,271,610)	1,271,610	—	—
Security repurchase agreements	(475,494)	—	(475,494)	475,494	—	—
Total Liabilities	$(1,834,701)	$—	$(1,834,701)	$1,765,695	$63,989	$(5,017)

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

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

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

(1) 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 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.

(2) Interest rate agreements, TBAs, and futures are components of derivatives instruments on our consolidated 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.

12

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

Note 4. Principles of Consolidation

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

Analysis of Consolidated VIEs

As of September 30, 2015, the VIEs we are required to consolidate include certain Sequoia securitization entities, the Residential Resecuritization entity, and the Commercial Securitization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

Table 4.1 – Assets and Liabilities of Consolidated VIEs

September 30, 2015 (Dollars in Thousands)	Sequoia Entities	Residential Resecuritization	Commercial Securitization	Total
Residential loans, held-for-investment	$1,170,246	$—	$—	$1,170,246
Commercial loans, held-for-investment	—	—	180,394	180,394
Real estate securities	—	181,253	—	181,253
Restricted cash	191	—	138	329
Accrued interest receivable	1,505	364	1,357	3,226
Other assets	3,902	—	—	3,902
Total Assets	$1,175,844	$181,617	$181,889	$1,539,350
Accrued interest payable	$770	$1	$318	$1,089
Asset-backed securities issued	1,105,588	5,261	67,946	1,178,795
Total Liabilities	$1,106,358	$5,262	$68,264	$1,179,884
Number of VIEs	24	1	1	26

Since 2012, we have transferred residential loans to 25 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 MSRs on our consolidated balance sheets, and classified those MSRs 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 MSRs (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

Note 4. Principles of Consolidation - (continued)

The following table presents information related to securitization transactions that occurred during the three and nine months ended September 30, 2015 and 2014.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2015	2014	2015	2014
Principal balance of loans transferred	$—	$635,608	$1,038,451	$982,913
Trading securities retained, at fair value	—	1,680	33,389	71,243
AFS securities retained, at fair value	—	39,330	6,309	59,757
MSRs recognized	—	4,356	7,874	6,542

The following table summarizes the cash flows during the three and nine months ended September 30, 2015 and 2014 between us and the unconsolidated VIEs sponsored by us.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2015	2014	2015	2014
Proceeds from new transfers	$—	$610,167	$1,018,312	$877,943
MSR fees received	3,817	3,571	11,287	10,618
Funding of compensating interest	(86)	(68)	(283)	(144)
Cash flows received on retained securities	8,190	16,190	31,541	44,417

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

	Issued During The Three Months Ended September 30, 2015			Nine Months Ended September 30, 2015		
At Date of Securitization	MSRs	Senior Securities	Subordinate Securities	MSRs	Senior Securities	Subordinate Securities
Prepayment rate	N/A	N/A	N/A	5 - 15%	8%	8%
Discount rates	N/A	N/A	N/A	11%	3%	6%
Credit loss assumptions	N/A	N/A	N/A	N/A	0.25%	0.25%

	Issued During The Three Months Ended September 30, 2014			Nine Months Ended September 30, 2014		
At Date of Securitization	MSRs	Senior Securities	Subordinate Securities	MSRs	Senior Securities	Subordinate Securities
Prepayment rate	5 - 16%	8%	8%	5 - 16%	8 - 10%	8 - 10%
Discount rates	11%	21%	5%	11%	3%	5%
Credit loss assumptions	N/A	0.25%	0.25%	N/A	0.25%	0.25%

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

Note 4. Principles of Consolidation - (continued)

The following table presents additional information at September 30, 2015 and December 31, 2014, related to unconsolidated securitizations accounted for as sales since 2012.

Table 4.5 – Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	September 30, 2015	December 31, 2014
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	$61,602	$93,802
Senior and subordinate securities, classified as AFS	292,948	460,990
Mortgage servicing rights	52,940	56,801
Maximum loss exposure [(1)]	$407,490	$611,593
Assets transferred:		
Principal balance of loans outstanding	$7,289,025	$7,276,825
Principal balance of delinquent loans 30+ days delinquent	14,204	17,022

(1) 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, 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, 2015 and December 31, 2014.

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

September 30, 2015 (Dollars in Thousands)	MSRs	Senior Securities [(1)]	Subordinate Securities