UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: March 31, 2002

OR

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

For the transition period from to

Commission file number: 1-13759

REDWOOD TRUST, INC.

(Exact name of Registrant as specified in its Charter)

Maryland (State or other jurisdiction of incorporation or organization)	**68-0329422** (I.R.S. Employer Identification No.)
591 Redwood Highway, Suite 3100 **Mill Valley, California** (Address of principal executive offices)	**94941** (Zip Code)

(415) 389-7373

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all documents and 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 ☐

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Class B Preferred Stock ($.01 par value)	902,068 as of May 10, 2002
Common Stock ($.01 par value)	15,334,537 as of May 10, 2002

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PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	March 31, 2002	December 31, 2001
	(Unaudited)	
ASSETS		
Residential mortgage loans	$1,794,260	$1,474,862
Residential credit-enhancement securities	249,832	190,813
Commercial mortgage loans	49,380	51,084
Securities portfolio	609,432	683,482
Cash and cash equivalents	9,960	9,030
Total Earning Assets	2,712,864	2,409,271
Restricted cash	2,334	3,399
Accrued interest receivable	13,101	13,729
Principal receivable	9,257	7,823
Other assets	2,282	1,422
Total Assets	$2,739,838	$2,435,644
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Short-term debt	$1,122,513	$ 796,811
Long-term debt, net	1,234,459	1,313,715
Accrued interest payable	2,224	2,569
Accrued expenses and other liabilities	6,450	6,498
Dividends payable	9,748	8,278
Total Liabilities	2,375,394	2,127,871
STOCKHOLDERS' EQUITY		
Preferred stock, par value $0.01 per share; Class B 9.74% Cumulative Convertible 902,068 shares authorized, issued and outstanding ($28,645 aggregate liquidation preference)	26,517	26,517
Common stock, par value $0.01 per share; 49,097,932 shares authorized; 14,624,647 and 12,661,749 issued and outstanding	146	127
Additional paid-in capital	374,854	328,668
Accumulated other comprehensive income	11,015	2,701
Cumulative earnings	71,861	59,961
Cumulative distributions to stockholders	(119,949)	(110,201)
Total Stockholders' Equity	364,444	307,773
Total Liabilities and Stockholders' Equity	$2,739,838	$2,435,644

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share data)
(Unaudited)

	Three Months Ended March 31,	
	2002	2001
Interest Income		
Residential mortgage loans	$ 14,125	$ 19,702
Residential credit-enhancement securities	6,695	2,642
Commercial mortgage loans	1,274	1,933
Securities portfolio	8,514	17,048
Cash and cash equivalents	108	312
Total interest income	30,716	41,637
Interest Expense		
Short-term debt	(4,941)	(13,575)
Long-term debt	(10,661)	(17,838)
Total interest expense	(15,602)	(31,413)
Net Interest Income	15,114	10,224
Operating expenses	(3,546)	(2,980)
Other income (expense)	(543)	(156)
Net unrealized and realized market value gains (losses)	875	2,641
Net income before preferred dividend and change in accounting principle	11,900	9,729
Dividends on Class B preferred stock	(681)	(681)
Net income before change in accounting principle	11,219	9,048
Cumulative effect of adopting EITF 99-20 (See Note 2)	—	(2,368)
Net Income Available to Common Stockholders	$ 11,219	$ 6,680
Earnings per Share:		
Basic Earnings Per Share:		
Net income before change in accounting principle	$ 0.82	$ 1.02
Cumulative effect of adopting EITF 99-20	$ —	$ (0.26)
Net income	$ 0.82	$ 0.76
Diluted Earnings Per Share:		
Net income before change in accounting principle	$ 0.80	$ 1.00
Cumulative effect of adopting EITF 99-20	$ —	$ (0.26)
Net income	$ 0.80	$ 0.74
Weighted average shares of common stock and common stock equivalents:		
Basic	13,658,443	8,838,964
Diluted	14,077,405	9,065,221

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(In thousands, except share data)
(Unaudited)

	Class B Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
	Shares	Amount	Shares	Amount					
Balance, December 31, 2001	902,068	$26,517	12,661,749	$ 127	$ 328,668	$ 2,701	$ 59,961	$ (110,201)	$307,773
Comprehensive income:									
Net income before preferred dividend	—	—	—	—	—	—	11,900	—	11,900
Net unrealized income on assets available-for-sale	—	—	—	—	—	8,314	—	—	8,314
Total comprehensive income	—	—	—	—	—	—	—	—	20,214
Issuance of common stock	—	—	1,962,898	19	46,186	—	—	—	46,205
Dividends declared:									
Preferred	—	—	—	—	—	—	—	(681)	(681)
Common	—	—	—	—	—	—	—	(9,067)	(9,067)
Balance, December 31, 2001	902,068	$26,517	14,624,647	$ 146	$ 374,854	$ 11,015	$ 71,861	$ (119,949)	$364,444

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2002	2001
Cash Flows From Operating Activities:		
Net income available to common stockholders before preferred dividend	$ 11,900	$ 7,361
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	3,331	1,291
Provision for credit losses	282	184
Non-cash stock compensation	42	143
Net unrealized and realized market value (gains) losses	(875)	(2,641)
Cumulative effect of adopting EITF 99-20	—	2,368
Purchases of mortgage loans held-for-sale	(417,251)	—
Principal payments on mortgage loans held-for-sale	8,658	2,172
Net (purchases) sales of mortgage securities trading	(9,904)	(288,944)
Principal payments on mortgage securities trading	53,149	65,726
Net sales (purchases) of interest rate agreements	—	(658)
Net change in:		
Accrued interest receivable	628	534
Principal receivable	(1,434)	2,549
Other assets	(991)	892
Accrued interest payable	(345)	(914)
Accrued expenses and other liabilities	(48)	1,375
Net cash used in operating activities	(352,858)	(208,562)
Cash Flows From Investing Activities:		
Purchases of mortgage loans held-for-investment	(165)	—
Proceeds from sales of mortgage loans held-for-investment	—	1,660
Principal payments on mortgage loans held-for-investment	89,140	60,779
Purchases of mortgage securities available-for-sale	(92,052)	(33,814)
Proceeds from sales of mortgage securities available-for-sale	60,531	3,034
Principal payments on mortgage securities available-for-sale	11,160	1,022
Net decrease in restricted cash	1,065	79
Net cash provided by investing activities	69,679	32,760
Cash Flows From Financing Activities:		
Net borrowings (repayments) on short-term debt	325,702	218,175
Proceeds from issuance of long-term debt	8,354	16,948
Repayments on long-term debt	(87,831)	(56,756)
Net proceeds from issuance of common stock	46,162	986
Dividends paid	(8,278)	(4,557)
Net cash provided by financing activities	284,109	174,796
Net increase (decrease) in cash and cash equivalents	930	(1,006)
Cash and cash equivalents at beginning of period	9,030	15,483
Cash and cash equivalents at end of period	$ 9,960	$ 14,477
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 15,947	$ 32,330

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2002
(Unaudited)

NOTE 1. THE COMPANY

Redwood Trust, Inc. (Redwood Trust) together with its subsidiaries, is a real estate finance company. Redwood Trust's primary business is owning, financing, and credit enhancing high-quality jumbo residential mortgage loans nationwide. Redwood Trust also finances real estate through its securities portfolio and its commercial loan portfolio. Redwood Trust's primary source of revenue is monthly payments made by homeowners on their mortgages, and its primary expense is the cost of borrowed funds. Redwood Trust is structured as a Real Estate Investment Trust (REIT) and, therefore, the majority of net earnings are distributed to shareholders as dividends.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements as of March 31, 2002 and 2001 are unaudited. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to present fairly the Company's financial position, results of operations and cash flows as of March 31, 2002 and 2001. These consolidated financial statements and notes thereto are unaudited and should be read in conjunction with the Company's audited consolidated financial statements included in the Company's Form 10-K for the year ended December 31, 2001. The results for the three months ended March 31, 2002 are not necessarily indicative of the expected results for the year ended December 31, 2002.

The March 31, 2002 and the December 31, 2001 consolidated financial statements include the accounts of Redwood Trust and its wholly-owned subsidiaries, Sequoia Mortgage Funding Corporation (Sequoia) and RWT Holdings, Inc. (Holdings). For financial reporting purposes, references to the Company mean Redwood Trust, Sequoia, and Holdings.

Substantially all of the assets of Sequoia, consisting primarily of residential whole loans shown as part of Residential Mortgage Loans, are subordinated to support long-term debt in the form of collateralized mortgage bonds (Long-Term Debt) and are not available for the satisfaction of general claims of the Company. The Company's exposure to loss on the assets which are collateral for Long-Term Debt is limited to its net equity investment in Sequoia and its net equity investment in three commercial mortgage loans, as the Long-Term Debt is non-recourse to the Company. All significant intercompany balances and transactions with Sequoia and Holdings have been eliminated in the consolidation of the Company at March 31, 2002. Certain amounts for prior periods have been reclassified to conform to the March 31, 2002 presentation.

On January 1, 2001, the Company acquired 100% of the voting common stock of Holdings for $300,000 in cash consideration from two officers of Holdings, and Holdings became a wholly-owned consolidated subsidiary of the Company. This transaction did not have a material effect on the consolidated financial statements of the Company.

Use of Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of certain revenues and expenses during the reported period. Actual results could differ from those estimates. The primary estimates inherent in the accompanying consolidated financial statements are discussed below.

Fair Value. Management estimates the fair value of its financial instruments using available market information and other appropriate valuation methodologies. The fair value of a financial instrument, as defined

by Statement of Financial Accounting Standards (SFAS) No. 107, *Disclosures about Fair Value of Financial Instruments,* is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced liquidation sale. Management's estimates are inherently subjective in nature and involve matters of uncertainty and judgment to interpret relevant market and other data. Accordingly, amounts realized in actual sales may differ from the fair values presented in Notes 3, 5, and 9.

Reserve for Credit Losses. A reserve for credit losses is maintained at a level deemed appropriate by management to provide for known credit losses, as well as losses inherent in Redwood's earning assets. The reserve is based upon management's assessment of various factors affecting its assets, including current and projected economic conditions, delinquency status, and credit protection. These estimates are reviewed periodically and adjusted as deemed necessary. The credit reserve on mortgage loans is increased by provisions, which are charged to income from operations. Summary information regarding the Reserve for Credit Losses on mortgage loans is presented in Note 4. The credit reserve on securities is established at acquisition and adjustments are made as further discussed below under EITF 99-20 and in Note 3. The Company's actual credit losses may differ from those estimates used to establish the reserve.

Individual mortgage loans are considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is impaired, impairment is measured based upon the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the underlying collateral. At March 31, 2002 and December 31, 2001, the Company had no impaired mortgage loans.

EITF 99-20. During 1999, the Emerging Issues Task Force (EITF) issued EITF 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.* EITF 99-20 established new income and impairment recognition standards for interests in certain securitized assets. Under the provisions of EITF 99-20, the holder of beneficial interests should recognize the excess of all estimated cash flows attributable to the beneficial interest estimated at the acquisition date over the initial investment (the accretable yield) as interest income over the life of the beneficial interest using the effective yield method. If the estimated cash flows change, then the holder of the beneficial interest should recalculate the accretable yield and adjust the periodic accretion recognized as income prospectively. If the fair value of a beneficial interest has declined below its carrying amount, an other-than-temporary decline is considered to exist if there has been a decline in estimated future cash flows. The difference between the carrying value and fair value of the beneficial interest is recorded as a mark-to-market impairment loss through the income statement. Any impairment adjustments under the provisions of EITF 99-20 are recognized as mark-to-market adjustments under Net Unrealized and Realized Market Value Gains (Losses) on the Consolidated Statement of Operations.

The Company adopted the provisions of EITF 99-20 effective January 1, 2001. At that date, the Company held certain beneficial interests where the current projections of cash flows were less than the cash flows anticipated at acquisition and the fair value had declined below the carrying value. Accordingly, the Company recorded a $2.4 million charge through the Statement of Operations during the quarter ended March 31, 2001 as a cumulative effect of a change in accounting principle. The mark-to-market adjustments on these beneficial interests had previously been recorded as unrealized losses through Accumulative Other Comprehensive Income as a component of Stockholders' Equity. Since this was a reclassification of declines in market values that had already been recognized in the Company's balance sheet and stockholders' equity accounts, there was no change in net carrying value of these interests upon adoption of EITF 99-20.

Risks and Uncertainties

The Company takes certain risks inherent in financial institutions, including, but not limited to, credit risk, liquidity risk, interest rate risk, prepayment risk, market value risk, and capital risk. In addition, there are several risks and uncertainties specific to Redwood Trust. The Company seeks to actively manage such risks while also providing stockholders an appropriate rate of return for risks taken. There can be no assurances that such risks and uncertainties are adequately provided for in the Company's financial statements, although management has prepared these financial statements in an effort to properly present the risks taken.

Earning Assets

The Company's earning assets consist primarily of residential and commercial real estate mortgage loans and securities (Earning Assets). Mortgage loans and securities pledged as collateral under borrowing arrangements in which the secured party has the right by contract or custom to sell or repledge the collateral have been classified as "pledged" as discussed in Note 3. Interest is recognized as revenue when earned according to the terms of the loans and securities and when, in the opinion of management, it is collectible. Purchase discounts and premiums relating to Earning Assets are amortized into interest income over the lives of the Earning Assets using the effective yield method based on projected cash flows over the life of the asset. Gains or losses on the sale of Earning Assets are based on the specific identification method. It is our intention to hold all of our loans and securities to maturity.

Mortgage Loans: Held-for-Investment

Mortgage loans held-for-investment are carried at their unpaid principal balance adjusted for net unamortized premiums or discounts and net of any allowance for credit losses. All of the Sequoia loans that are pledged or subordinated to support the Long-Term Debt are classified as held-for-investment. Commercial loans that the Company has secured financing through the term of the loan or otherwise has the intent and the ability to hold to maturity, are classified as held-for-investment.

Mortgage Loans: Held-for-Sale

Mortgage loans held-for-sale (residential and commercial) are carried at the lower of original cost or aggregate market value. Realized and unrealized gains and losses on these loans are recognized in Net Unrealized and Realized Market Value Gains (Losses) on the Consolidated Statements of Operations. Real estate owned assets of the Company are included in mortgage loans held-for-sale.

Securities: Trading

Securities trading are recorded at their estimated fair market value. Unrealized and realized gains and losses on these securities are recognized as a component of Net Unrealized and Realized Market Value Gains (Losses) on the Consolidated Statements of Operations.

Securities: Available-for-Sale

Securities available-for-sale are carried at their estimated fair value. Current period unrealized gains and losses are excluded from net income and reported as a component of Other Comprehensive Income in Stockholders' Equity with cumulative unrealized gains and losses classified as Accumulated Other Comprehensive Income in Stockholders' Equity.

Interest income on loans and securities is calculated using the effective yield method based on projected cash flows over the life of the asset. Yields on each asset vary as a function of credit results, prepayment rates, and interest rates. For Residential Credit-Enhancement Securities purchased at a discount, a portion of the discount for each security is designated as a credit reserve, with the remaining portion of the discount designated to be amortized into income over the life of the security using the effective yield method. If future credit losses exceed the Company's original expectations, or credit losses occur more quickly than expected, or prepayment rates occur more slowly than expected, the yield over the remaining life of the security may be adjusted downwards or the Company may take a mark-to-market earnings charge to write down the basis in the security to current market value. If future credit losses are less than the Company's original estimate, or credit losses occur later than expected, or prepayment rates are faster than expected, the yield over the remaining life of the security may be adjusted upwards.

Cash and Cash Equivalents

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

Restricted Cash

Restricted cash of the Company may include principal and interest payments on mortgage loans held as collateral for the Company's Long-Term Debt, cash pledged as collateral on certain interest rate agreements, and cash held back from borrowers until certain loan agreement requirements have been met. Any corresponding liability for cash held back from borrowers is included in Accrued Expenses and Other Liabilities on the Consolidated Balance Sheets.

Other Assets

Other Assets on the Consolidated Balance Sheets include fixed assets, prepaid interest and other prepaid expenses.

Interest Rate Agreements

The Company maintains an overall interest-rate risk-management strategy that may incorporate the use of derivative interest rate agreements for a variety of reasons, including minimizing significant fluctuations in earnings that may be caused by interest-rate volatility. Interest rate agreements the Company may use as part of its interest-rate risk management strategy include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchases (collectively Interest Rate Agreements). On the date an Interest Rate Agreement is entered into, the Company designates the Interest Rate Agreement as (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge), or (3) held for trading (trading instruments).

The Company has elected not to seek hedge accounting under SFAS No. 133 for any of its Interest Rate Agreements through March 31, 2002. Accordingly, such instruments are designated as trading and are recorded at their estimated fair market value with changes in their fair value reported in current-period earnings in Net Unrealized and Realized Market Value Gains (Losses) on the Consolidated Statements of Operations. The Company may elect to seek hedge accounting based on the provisions of SFAS No. 133 in the future.

Net premiums on Interest Rate Agreements are amortized as a component of net interest income over the effective period of the Interest Rate Agreement using the effective interest method. The income or expense related to Interest Rate Agreements is recognized on an accrual basis and is included in interest expense on short-term debt in the Consolidated Statements of Operations.

Debt

Short-Term Debt and Long-Term Debt are carried at their unpaid principal balances net of any unamortized discount or premium and any unamortized deferred bond issuance costs. The amortization of any discount or premium is recognized as an adjustment to interest expense using the effective interest method based on the maturity schedule of the related borrowings. Bond issuance costs incurred in connection with the issuance of Long-Term Debt are deferred and amortized over the estimated lives of the Long-Term Debt using the interest method, adjusted for the effects of estimated principal paydown rates.

Income Taxes

The Company has elected to be taxed as a REIT under the Internal Revenue Code (the Code) and the corresponding provisions of state law. In order to qualify as a REIT, the Company must annually distribute at least 90% of its taxable income to stockholders and meet certain other requirements. If these requirements are met, the Company generally will not be subject to Federal or state income taxation at the corporate level with respect to the taxable income it distributes to its stockholders. Because the Company believes it meets the REIT requirements and also intends to distribute all of its taxable income, no provision has been made for income taxes in the accompanying consolidated financial statements.

Under the Code, a dividend declared by a REIT in October, November, or December of a calendar year and payable to shareholders of record as of a specified date in such year, will be deemed to have been paid by the

Company and received by the shareholders on the last day of that calendar year, provided the dividend is actually paid before February 1st of the following calendar year, and provided that the REIT has any remaining undistributed taxable income on the record date. Therefore, the dividends declared in the fourth quarter 2001, which were paid in January 2002, are considered taxable income to stockholders in 2001, the year declared. All 2001 dividends were ordinary income to the Company's preferred and common stockholders.

Taxable earnings of Holdings are subject to state and Federal income taxes at the applicable statutory rates. Holdings provides for deferred income taxes, if any, to reflect the estimated future tax effects under the provisions of SFAS No. 109, *Accounting for Income Taxes*. Under this pronouncement, deferred income taxes, if any, reflect the estimated future tax effects of temporary differences between the amount of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws and regulations.

Net Income Per Share

Basic net income per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income available to common stockholders by the weighted average number of common shares and common equivalent shares outstanding during the period. The common equivalent shares are calculated using the treasury stock method, which assumes that all dilutive common stock equivalents are exercised and the funds generated by the exercise are used to buy back outstanding common stock at the average market price during the reporting period.

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The following tables provide reconciliations of the numerators and denominators of the basic and diluted net income (loss) per share computations.

(in thousands, except share data)	Three Months Ended March 31, 2002	2001
Numerator:		
Numerator for basic and diluted earnings per share —		
Net income before preferred dividend and change in accounting principle	$ 11,900	$ 9,729
Cash dividends on Class B preferred stock	(681)	(681)
Net income before change in accounting principle	11,219	9,048
Cumulative effect of adopting EITF 99-20	—	(2,368)
Basic and Diluted EPS — Net income available to common stockholders	$ 11,219	$ 6,680
Denominator:		
Denominator for basic earnings per share —		
Weighted average number of common shares outstanding during the period	13,658,443	8,838,964
Net effect of dilutive stock options	418,962	226,257
Denominator for diluted earnings per share	14,077,405	9,065,221
Basic Earnings Per Share:		
Net income before change in accounting principle	$ 0.82	$ 1.02
Cumulative effect of adopting EITF 99-20	—	(.26)
Net income per share	$ 0.82	$ 0.76
Diluted Earnings Per Share:		
Net income before change in accounting principle	$ 0.80	$ 1.00
Cumulative effect of adopting EITF 99-20	—	(.26)
Net income per share	$ 0.80	$ 0.74

The number of common equivalent shares issued by the Company that were anti-dilutive during the three months ended March 31, 2002 totaled 390,662.

Comprehensive Income

Current period unrealized gains and losses on assets available-for-sale are reported as a component of Comprehensive Income on the Consolidated Statements of Stockholders' Equity with cumulative unrealized gains and losses classified as Accumulated Other Comprehensive Income in Stockholders' Equity. At March 31, 2002 and December 31, 2001, the only component of Accumulated Other Comprehensive Income was net unrealized gains and losses on assets available-for-sale.

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board issued SFAS No. 141, *Business Combinations* and SFAS 142, *Goodwill and Other Intangible Assets*. SFAS No. 141, among other things, eliminates the use of the pooling of interests method of accounting for business combinations. SFAS No. 141 is effective for all business combinations initiated after June 30, 2001. Under the provisions of SFAS No. 142, goodwill will no longer be amortized, but will be subject to a periodic test for impairment based upon fair values. SFAS No. 142 is effective beginning January 1, 2002. The adoption of these statements did not have a material effect on the Company's financial statements.

NOTE 3. EARNING ASSETS

At March 31, 2002 and December 31, 2001, investments in Earning Assets generally consisted of interests in adjustable-rate, hybrid, or fixed-rate residential and commercial real estate mortgage loans and securities. Hybrid mortgages have an initial fixed coupon rate for three to ten years followed by annual adjustments. The original maturity of the majority of our residential mortgage assets is twenty-five to thirty years. The actual amount of principal outstanding is subject to change based on the prepayments of the underlying mortgage loans. The original maturity of the majority of our commercial mortgage assets is three years.

At March 31, 2002 and 2001, the annualized effective yield after taking into account the amortization income or expense due to discounts and premiums and associated credit expenses on the Earning Assets was 4.92% and 7.72%, respectively, based on the reported carrying value of the assets. For the three months ended March 31, 2002 and 2001, the average balance of Earning Assets was $2.5 billion and $2.2 billion, respectively.

At March 31, 2002 and December 31, 2001, Earning Assets consisted of the following:

Residential Mortgage Loans

(in thousands)	March 31, 2002 Held-for-Sale	March 31, 2002 Held-for-Investment	March 31, 2002 Total	December 31, 2001 Held-for-Sale	December 31, 2001 Held-for-Investment	December 31, 2001 Total
Current Face	$562,261	$1,227,978	$1,790,239	$153,125	$1,317,343	$1,470,468
Unamortized Discount	(308)	—	(308)	(364)	(132)	(496)
Unamortized Premium	1,503	8,307	9,810	34	10,055	10,089
Amortized Cost	563,456	1,236,285	1,799,741	152,795	1,327,266	1,480,061
Reserve for Credit Losses	—	(5,481)	(5,481)	—	(5,199)	(5,199)
Carrying Value	$563,456	$1,230,804	$1,794,260	$152,795	$1,322,067	$1,474,862

At March 31, 2002 and December 31, 2001, residential mortgage loans with a net carrying value of $563 million and $148 million were pledged as collateral under short-term borrowing arrangements to third parties.

Residential Credit-Enhancement Securities

(in thousands)	March 31, 2002 Mortgage Securities Available-for-Sale	December 31, 2001 Mortgage Securities Available-for-Sale
Current Face	$ 460,035	$ 353,435
Unamortized Discount	(28,058)	(25,863)
Portion Of Discount Designated As A Credit Reserve	(194,556)	(140,411)
Amortized Cost	237,421	187,161
Gross Unrealized Gains	16,204	7,174
Gross Unrealized Losses	(3,793)	(3,522)
Carrying Value	$ 249,832	$ 190,813

The Company credit enhances pools of high-quality jumbo residential mortgage loans by acquiring subordinated securities in third-party securitizations. The subordinated interests in a securitization transaction bear the majority of the credit risk for the securitized pool of mortgages, thus allowing the more senior securitized interests to qualify for investment-grade ratings and to be sold in the capital markets. The Company therefore commits capital that effectively forms a “guarantee” or “insurance” on the securitized pool of mortgages.

The Company’s Residential Credit-Enhancement Securities are first-loss, second-loss, and third-loss securities. First-loss securities are generally allocated actual credit losses on the entire underlying pool of loans up to a maximum of the principal amount of the first loss security. First-loss securities provide credit-enhancement

principal protection from the initial losses in the underlying pool for the second loss, third loss, and more senior securities. Any first loss securities that are owned by others and that are junior to the Company's second and third loss securities provide the Company's securities with some protection from losses, as they serve as external credit enhancement. The Company provided some level of credit enhancement on $65 billion and $52 billion of loans securitized by third parties at March 31, 2002 and December 31, 2001, respectively.

When the Company purchases residential credit enhancement interests, a portion of the discount for each security is designated as a credit reserve, with the remaining portion of the discount designated to be amortized into income over the life of the security using the effective yield method. If future credit losses exceed the Company's original expectations, and the fair value of the security is less than its carrying value, the Company will record a charge on the Statement of Operations to write down the basis in the security. If future credit losses exceed the Company's original expectations, and the fair value of the security is greater than its carrying value, the yield over the remaining life of the security may be adjusted downward. If future credit losses are less than the Company's original estimate, the yield over the remaining life of the security may be adjusted upward. At March 31, 2002 and December 31, 2001, the Company designated $195 million and $140 million as a credit reserve on its residential credit-enhancement interests, respectively.

At March 31, 2002 and December 31, 2001, Residential Credit-Enhancement Securities with a net carrying value of $66 million and $89 million, respectively, were pledged as collateral under borrowing arrangements to third parties.

Commercial Mortgage Loans

	March 31, 2002			December 31, 2001		
(in thousands)	Held-for-Sale	Held-for-Investment	Total	Held-for-Sale	Held-for-Investment	Total
Current Face	$19,271	$30,786	$50,057	$30,931	$20,860	$51,791
Unamortized Discount	(533)	(144)	(677)	(683)	(24)	(707)
Carrying Value	$18,738	$30,642	$49,380	$30,248	$20,836	$51,084

At March 31, 2002, there were no commercial mortgage loans pledged as collateral under short-term borrowing arrangements to third parties. At December 31, 2001, commercial mortgage loans with a net carrying value of $19 million were pledged as collateral under short-term borrowing arrangements to third parties. At March 31, 2002 and December 31, 2001, commercial mortgage loans held-for-investment with a net carrying value of $31 million and $21 million, respectively, were pledged as collateral under long-term borrowing arrangements to third parties.

Securities Portfolio

(in thousands)	March 31, 2002 Securities Portfolio Trading	March 31, 2002 Securities Portfolio Available-for-Sale	March 31, 2002 Total	December 31, 2001 Securities Portfolio Trading	December 31, 2001 Securities Portfolio Available-for-Sale	December 31, 2001 Total
Current Face	$459,536	$142,390	$601,926	$501,078	$171,877	$672,955
Unamortized Discount	(604)	(567)	(1,171)	(139)	(1,320)	(1,459)
Unamortized Premium	4,456	5,616	10,072	6,634	6,303	12,937
Amortized Cost	463,388	147,439	610,827	507,573	176,860	684,433
Gross Unrealized Gains	—	402	402	—	516	516
Gross Unrealized Losses	—	(1,797)	(1,797)	—	(1,467)	(1,467)
Carrying Value	$463,388	$146,044	$609,432	$507,573	$175,909	$683,482
Agency	$285,174	$ 0	$285,174	$353,523	$ 20,223	$373,746
Non-Agency	178,214	146,044	324,258	154,050	155,686	309,736
Carrying Value	$463,388	$146,044	$609,432	$507,573	$175,909	$683,482

For the three months ended March 31, 2002 and 2001, the Company recognized net market value gains through the Consolidated Statement of Operations of $0.9 million and $3.0 million on its securities portfolio, respectively.

At March 31, 2002 and December 31, 2001, securities portfolio assets with a net carrying value of $539 million and $592 million, respectively, were pledged as collateral under borrowing arrangements to third parties.

NOTE 4. RESERVE FOR CREDIT LOSSES

The Reserve for Credit Losses is for Residential Mortgage Loans held-for-investment and is reflected as a component of Earning Assets on the Consolidated Balance Sheets. The following table summarizes the activity in the Reserve for Credit Losses:

(in thousands)	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001
Balance at beginning of period	$ 5,199	$ 4,814
Provision for credit losses	282	184
Charge-offs	—	(30)
Balance at end of period	$ 5,481	$ 4,968

NOTE 5. INTEREST RATE AGREEMENTS

Through March 31, 2002, the Company reports its Interest Rate Agreements at fair value, and has not elected to obtain hedge accounting treatment under SFAS No. 133 on any of its Interest Rate Agreements. At both March 31, 2002 and December 31 2001, the fair value of the Company's Interest Rate Agreements was $0. Interest Rate Agreements are included in Other Assets on the Consolidated Balance Sheets.

During the three months ended March 31, 2002, the Company did not recognize any gains or losses on Interest Rate Agreements. During the three months ended March 31, 2001, the Company recognized net market value losses of $0.5 million on Interest Rate Agreements. The market value gains and losses are included in Net Unrealized and Realized Market Value Gains (Losses) on the Consolidated Statements of Operations.

The Company generally attempts to structure its balance sheet to address many of the interest rate risks inherent in financial institutions. The Company may enter into certain Interest Rate Agreements from time to

time with the objective of matching the interest rate characteristics of its assets and liabilities. At March 31, 2002, the Company was not actively using Interest Rate Agreements to hedge its portfolio of Earning Assets. The Company had two interest rate caps with strike rates based on the one month London Interbank Offered Rate (LIBOR) interest rate ranging from 7.00% to 10.10% expiring in 2002 and 2003 and two generally offsetting interest rate swaps between Redwood Trust, Sequoia and a third party financial institution. At March 31, 2002 and December 31, 2001, these generally offsetting interest rate swaps had gross notional amounts of $423.8 million and $445.1 million, respectively. The swap between Redwood and the third party financial institution required Redwood to provide collateral in the form of agency securities of $7.1 million and $6.6 million at March 31, 2002 and December 31, 2001, respectively. Sequoia did not hold collateral of the third party financial institution for its swap at March 31, 2002 or December 31, 2001.

In the future, the Company may enter into Interest Rate Agreements consisting of interest rate caps, interest rate floors, interest rate futures, options on interest rate futures, interest rate swaps, and other types of hedging instruments.

The following table summarizes the aggregate notional amounts of all of the Company's Interest Rate Agreements as well as the credit exposure related to these instruments as of March 31, 2002 and December 31, 2001. The credit exposure reflects the fair market value of any cash and collateral of the Company held by counterparties. The cash and collateral held by counterparties are included in Restricted Cash or the Securities Portfolio on the Consolidated Balance Sheets.

	Notional Amounts		Credit Exposure	
(in thousands)	March 31, 2002	December 31, 2001	March 31, 2002	December 31, 2001
Interest Rate Options Purchased	$ 8,000	$ 313,000	—	—
Interest Rate Swaps	423,787	445,107	$ 7,050	$ 6,645
Total	$431,787	$ 758,107	$ 7,050	$ 6,645

In general, the Company incurs credit risk to the extent that the counterparties to the Interest Rate Agreements do not perform their obligations under the Interest Rate Agreements. If one of the counterparties does not perform, the Company would not receive the cash to which it would otherwise be entitled under the Interest Rate Agreement. In order to mitigate this risk, the Company has only entered into Interest Rate Agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the U.S. Department of the Treasury as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated BBB or higher. Furthermore, the Company has entered into Interest Rate Agreements with several different counterparties in order to diversify the credit risk exposure.

NOTE 6. SHORT-TERM DEBT

The Company has entered into repurchase agreements, bank borrowings, and other forms of collateralized short-term borrowings (collectively, Short-Term Debt) to finance of a portion of its Earning Assets.

At March 31, 2002, the Company had $1.1 billion of Short-Term Debt outstanding with a weighted-average borrowing rate of 2.25% and a weighted-average remaining maturity of 78 days. This debt was collateralized with $1.2 billion of Earning Assets. At December 31, 2001, the Company had $0.8 billion of Short-Term Debt outstanding with a weighted-average borrowing rate of 2.19% and a weighted-average remaining maturity of 82 days. This debt was collateralized with $0.8 billion of Earning Assets.

At March 31, 2002 and December 31, 2001, the Short-Term Debt had the following remaining maturities:

(in thousands)	March 31, 2002	December 31, 2001
Within 30 days	$ 455,140	$ 270,855
31 to 90 days	431,655	226,407
Over 90 days	235,718	299,549
Total Short-Term Debt	$ 1,122,513	$ 796,811

For both the three months ended March 31, 2002 and 2001, the average balance of Short-Term Debt was $0.9 billion, with a weighted-average interest cost of 2.12% and 5.91%, respectively. The maximum balance outstanding during the three months ended March 31, 2002 and 2001, was $1.1 billion and $1.0 billion, respectively. The Company continues to meet all of its debt covenants for its short-term borrowing arrangements and credit facilities.

At March 31, 2002, the Company had uncommitted facilities with credit lines in excess of $4 billion for financing AAA and AA-rated residential mortgage securities. It is the intention of the Company's management to renew committed and uncommitted facilities as needed.

At March 31, 2002 and December 31, 2001, the Company had short-term facilities with two Wall Street Firms totaling $1.0 billion to fund Residential Mortgage Loans. At March 31, 2002 and December 31, 2001, the Company had borrowings under these facilities of $551 million and $146 million, respectively. Borrowings under these facilities bear interest based on a specified margin over the one-month LIBOR interest rate. At March 31, 2002 and December 31, 2001, the weighted average borrowing rate under these facilities was 2.49% and 2.56%, respectively. These facilities expire in June and December 2002.

At March 31, 2002, the Company had two committed revolving mortgage warehousing credit facilities totaling $57 million to finance commercial mortgage loans. At March 31, 2002, the Company had no borrowings under these facilities. At December 31, 2001, the Company had borrowings under these facilities of $17 million. One of the facilities allows for loans to be financed to the maturity of the loan, up to three years. Borrowings under these facilities bear interest based on a specified margin over the one-month LIBOR interest rate. At March 31, 2002, the weighted average borrowing rate under these facilities was 3.88%. These facilities expire in May and September 2002.

At March 31, 2002, the Company had four master repurchase agreements with two banks and two Wall Street Firms totaling $170 million. At December 31, 2001, the Company had three master repurchase agreements with a bank and two Wall Street Firms totaling $140 million. These facilities are intended to finance securities with lower than investment grade ratings. At March 31, 2002 and December 31, 2001, the Company had borrowings under these facilities of $40 million and $66 million, respectively. Borrowings under these facilities bear interest based on a specified margin over the one-month LIBOR interest rate. At March 31, 2002 and December 31, 2001, the weighted average borrowing rate under these facilities was 2.98% and 2.92%, respectively. The Company does not intend to renew a facility expiring in May 2002. Two other facilities expire in September 2002 and February 2003. The fourth facility has a six-month term that is extended monthly. Unless notice is provided by either party the expiration on this fourth facility will remain at six months.

NOTE 7. LONG-TERM DEBT

Through securitization, the Company issues Residential Long-Term Debt in the form of collateralized mortgage bonds secured by Residential Mortgage Loans (Residential Bond Collateral). The Residential Bond Collateral consists primarily of adjustable-rate and hybrid, conventional, 30-year residential mortgage loans secured by first liens on one- to four-family residential properties. All Residential Bond Collateral is pledged to secure repayment of the related Residential Long-Term Debt obligation. As required by the indentures relating to the Residential Long-Term Debt, the Residential Bond Collateral is held in the custody of trustees. The trustees collect principal and interest payments (less servicing and related fees) on the Residential Bond Collateral and make corresponding principal and interest payments on the Residential Long-Term Debt. The obligations under the Residential Long-Term Debt are payable solely from the Residential Bond Collateral and are otherwise non-recourse to the Company.

Each series of Residential Long-Term Debt consists of various classes of bonds at variable rates of interest. The maturity of each class is directly affected by the rate of principal prepayments on the related Residential Bond Collateral. Each series is also subject to redemption according to the specific terms of the respective indentures. As a result, the actual maturity of any class of a Residential Long-Term Debt series is likely to occur earlier than its stated maturity.

The Commercial Long-Term Debt is secured by three adjustable-rate Commercial Mortgage Loans with maturity dates in 2002 or 2003, which are secured by first liens on the related commercial mortgage properties (Commercial Loan Collateral).

The Company's exposure to loss on the Residential Bond Collateral and the Commercial Loan Collateral is limited to its net investment, as the Residential and Commercial Long-Term Debt are non-recourse to the Company.

The components of the collateral for the Company's Long-Term Debt are summarized as follows:

(in thousands)	March 31, 2002	December 31, 2001
Residential Mortgage Loans:		
Residential Mortgage Loans held-for-sale	$ 1,060	$ 848
Residential Mortgage Loans held-for-investment	1,230,804	1,322,067
Restricted cash	2,334	2,534
Accrued interest receivable	4,115	5,340
Total Residential Collateral	$ 1,238,313	$ 1,330,789
Commercial Mortgage Loans held-for-investment	$ 30,642	$ 20,836
Total Long-Term Debt Collateral	$ 1,268,955	$ 1,351,625

The components of the Long-Term Debt at March 31, 2002 and December 31, 2001 along with selected other information are summarized below:

(in thousands)	March 31, 2002	December 31, 2001
Residential Long-Term Debt	$ 1,210,126	$ 1,297,958
Commercial Long-Term Debt	25,648	17,211
Unamortized premium on Long-Term Debt	1,839	2,038
Deferred bond issuance costs	(3,154)	(3,492)
Total Long-Term Debt	$ 1,234,459	$ 1,313,715
Range of weighted-average interest rates, by series — residential	2.24% to 6.78%	2.28% to 6.35%
Stated residential maturities	2017 - 2029	2017 - 2029
Number of residential series	5	5
Weighted-average interest rates — commercial	6.07%	5.09%
Stated commercial maturities	2002 - 2003	2002 - 2003
Number of commercial series	3	2

For the three months ended March 31, 2002 and 2001, the average effective interest cost for Residential Long-Term Debt, as adjusted for the amortization of bond premium, deferred bond issuance costs, and other related expenses, was 3.30% and 6.65%, respectively. At March 31, 2002 and December 31, 2001, accrued interest payable on Residential Long-Term Debt was $1.7 million and $1.9 million, respectively, and is reflected as a component of Accrued Interest Payable on the Consolidated Balance Sheets. For the three months ended March 31, 2002 and 2001, the average balance of Residential Long-Term Debt was $1.3 billion and $1.1 billion, respectively.

At March 31, 2002 and December 31, 2001, the weighted average interest rate for Commercial Long-Term Debt was 6.07% and 5.09%, and the balance of Commercial Long-Term Debt was $25.6 million and $17.2 million, respectively.

NOTE 8. INCOME TAXES

As a REIT, Redwood Trust can exclude dividends for taxable income and thus, effectively, may not be subject to income taxes. Holdings, the Company's taxable REIT subsidiary, is subject to income taxes.

The current provision for income taxes for Holdings for the three months ended March 31, 2002 and 2001 was $3,200 and was a component of Operating Expenses on the Consolidated Statement of Operations. These amounts represent the minimum California franchise taxes. No additional tax provision has been recorded for the three months ended March 31, 2002 and 2001 as taxable income reported for these periods was offset by Federal and state net operating loss carryforwards from prior years. In addition, due to the uncertainty of realization of net operating losses, no deferred tax benefit has been recorded. A valuation allowance has been provided to offset the deferred tax assets related to net operating loss carryforwards and other future temporary deductions at March 31, 2002 and December 31, 2001. At March 31, 2002 and December 31, 2001, the deferred tax assets and associated valuation allowances were approximately $9.2 million and $9.3 million, respectively. At March 31, 2002 and December 31, 2001, Holdings had net operating loss carryforwards of approximately $24.2 million and $24.4 million for Federal tax purposes, and $10.1 million and $10.4 million for state tax purposes, respectively. The Federal loss carryforwards and a portion of the state loss carryforwards expire between 2018 and 2021, while the largest portion of the state loss carryforwards expire between 2003 and 2006.

NOTE 9. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents the carrying values and estimated fair values of the Company's financial instruments at March 31, 2002 and December 31, 2001.

	March 31, 2002		December 31, 2001	
(in thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Mortgage Loans				
Residential: held-for-sale	$ 563,456	$ 563,456	$ 152,795	$ 152,795
Residential: held-for-investment	1,230,804	1,233,651	1,322,067	1,318,673
Commercial: held-for-sale	18,738	18,738	30,248	30,248
Commercial: held-for-investment	30,642	30,786	20,836	20,860
Mortgage Securities				
Residential: trading	463,388	463,388	507,573	507,573
Residential: available-for-sale	395,876	395,876	366,722	366,722
Liabilities				
Short-Term Debt	1,122,513	1,122,513	796,811	796,811
Long-Term Debt	1,234,459	1,229,561	1,313,715	1,295,323

The carrying values of all other balance sheet accounts as reflected in the financial statements approximate fair value because of the short-term nature of these accounts.

NOTE 10. STOCKHOLDERS' EQUITY

Class B 9.74% Cumulative Convertible Preferred Stock

On August 8, 1996, the Company issued 1,006,250 shares of Class B Preferred Stock (Preferred Stock). Each share of the Preferred Stock is convertible at the option of the holder at any time into one share of Common Stock. Effective October 1, 1999, the Company can either redeem the Preferred Stock or, under certain circumstances, cause a conversion of the Preferred Stock into Common Stock. The Preferred Stock pays a dividend equal to the greater of (i) $0.755 per share, per quarter or (ii) an amount equal to the quarterly dividend declared on the number of shares of the Common Stock into which the Preferred Stock is convertible. The Preferred Stock ranks senior to the Company's Common Stock as to the payment of dividends and liquidation rights. The liquidation preference entitles the holders of the Preferred Stock to

receive $31.00 per share plus any accrued dividends before any distribution is made on the Common Stock. At both March 31, 2002 and December 31, 2001, 96,732 shares of the Preferred Stock have been converted into 96,732 shares of the Company's Common Stock.

In March 1999, the Company's Board of Directors approved the repurchase of up to 150,000 shares of the Company's Preferred Stock. The Company did not repurchase any shares of Preferred Stock during the three months ended March 31, 2002 and 2001. At March 31, 2002, there remained 142,550 shares available under the authorization for repurchase.

Stock Option Plan

The Company adopted a Stock Option Plan for executive officers, employees, and non-employee directors (the Plan). The Plan authorizes the Board of Directors (or a committee appointed by the Board of Directors) to grant incentive stock options as defined under Section 422 of the Code (ISOs), options not so qualified (NQSOs), deferred stock, restricted stock, performance shares, stock appreciation rights, limited stock appreciation rights (Awards), and dividend equivalent rights (DERs) to such eligible recipients other than non-employee directors. Non-employee directors are automatically provided annual grants of NQSOs under the Plan.

The number of shares of Common Stock available under the Plan for options and Awards, subject to certain anti-dilution provisions, is 15% of the Company's total outstanding shares of Common Stock. The total outstanding shares are determined as the highest number of shares outstanding prior to any stock repurchases. At March 31, 2002 and December 31, 2001, 305,404 and 299,064 shares of Common Stock, respectively, were available for grant.

Of shares of Common Stock available for grant, no more than 500,000 shares of Common Stock shall be cumulatively available for grant as ISOs. At March 31, 2002 and December 31, 2001, 459,137 and 458,537 ISOs had been granted, respectively. The exercise price for ISOs granted under the Plan may not be less than the fair market value of shares of Common Stock at the time the ISO is granted. At both March 31, 2002 and December 31, 2001, 28,000 shares of restricted stock had been granted to two officers of the Company. The restrictions on 7,000 of these shares expired on January 1, 2002. The restrictions on 6.25% of the total restricted shares expire on the first day of each calendar quarter starting April 1, 2002, and continuing through January 1, 2005.

The Company has granted stock options that accrue and pay stock and cash DERs. This feature results in current expenses being incurred that relate to long-term incentive grants made in the past. To the extent the Company increases its common dividends or the market price of the Common Stock increases, stock and cash DER expenses may increase. For the three months ended March 31, 2002 and 2001, the Company accrued cash and stock DER expenses of $1.2 million and $0.7 million, respectively, which was included in Operating Expenses in the Consolidated Statement of Operations. Stock DERs represent shares of stock which are issuable when the holders exercise the underlying stock options and are considered to be variable stock awards under the provisions of Accounting Principles Board Opinion 25. For the three months ended March 31, 2002 and 2001, the Company recognized variable stock option expense of $0.5 million and $0.2 million, respectively, which was included in Other Income (Expense) on the Consolidated Statement of Operations. The number of stock DER shares accrued was based on the level of the Company's common stock dividends and on the price of the common stock on the related dividend payment dates. At March 31, 2002 and December 31, 2001, there were 185,166 and 181,010 unexercised options with stock DERs under the Plan, respectively. Cash DERs were accrued and paid based on the level of the Company's common stock dividend. At March 31, 2002 and December 31, 2001, there were 1,283,984 and 1,284,222 unexercised options with cash DERs under the Plan, respectively. At March 31, 2002 and December 31, 2001, there were 151,456 and 153,269 outstanding stock options that did not have DERs, respectively.

A summary of the status of the Plan at March 31, 2002 and changes during the quarter ending on that date is presented below.

	March 31, 2002	
(in thousands, except share data)	Shares	Weighted Average Exercise Price
Outstanding options at beginning of period	1,618,501	$22.33
Options granted	600	$26.58
Options exercised	(1,625)	$17.63
Options canceled	(1,026)	$14.38
Dividend equivalent rights earned	4,156	—
Outstanding options at end of period	1,620,606	$22.29

In March 2002, the Company's Board of Directors approved, subject to shareholder approval, the 2002 Redwood Trust, Inc. Incentive Stock Plan (Incentive Stock Plan). The Incentive Stock Plan is intended to replace the Plan discussed above (Prior Plan) with respect to all future grants of stock-related awards.

Subject to anti-dilution provisions for stock splits, stock dividends and similar events, the Incentive Stock Plan authorizes the grant of awards with respect to a maximum number of shares equal to the sum of: (i) 400,000 shares of common stock; (ii) 299,064 shares of common stock available for future awards under the Prior Plan as of March 1, 2002; (iii) any shares of common stock that are represented by awards granted under the Prior Plan which are (A) forfeited, expire or are canceled without delivery of shares of common stock or (B) settled in cash; and (iv) any shares of common stock that are represented by awards granted under the Prior Plan which are tendered to the Company to satisfy the exercise price of options or the applicable tax withholding obligation.

In May 2002, the shareholders approved the Incentive Stock Plan.

Common Stock Repurchases

The Company's Board of Directors approved the repurchase a total of 7,455,000 shares of the Company's Common Stock. The Company did not repurchase any shares of Common Stock during the three months ended March 31, 2002 and 2001. At March 31, 2002, there remained 1,000,000 shares available under the authorization for repurchase. The repurchased shares have been returned to the Company's authorized but unissued shares of Common Stock.

Common Stock Issuances

In February 2002, the Company completed a secondary offering of 1,725,000 shares of common stock for net proceeds of $40.3 million. The Company also issued 239,119 shares of common stock through its Dividend Reinvestment and Stock Purchase Plan for net proceeds of $5.9 million during the first quarter ended March 31, 2002.

NOTE 11. COMMITMENTS AND CONTINGENCIES

At March 31, 2002, the Company had entered into commitments to purchase $2 million of securities and $162 million of residential mortgage loans for settlement in April 2002. At March 31, 2002, the Company had entered into commitments to sell $30 million of securities.

At March 31, 2002, the Company is obligated under non-cancelable operating leases with expiration dates through 2006. The total future minimum lease payments under these non-cancelable leases are $2.4 million and are expected to be expensed as follows: 2002 — $0.5 million; 2003 — $0.6 million; 2004 — $0.6 million; 2005 — $0.5 million; 2006 — $0.2 million.

NOTE 12. SUBSEQUENT EVENTS

In April 2002, the Company completed a secondary offering of 575,000 shares of common stock for net proceeds of $14.9 million to fund the continued expansion of its real estate finance business.

In April 2002, the Company issued $502 million in face value of Long-Term Debt through Sequoia Mortgage Trust 6, a trust established by Sequoia. This debt is collateralized by a pool of adjustable-rate residential mortgage loans. The proceeds received from this issuance were used to pay down a portion of the Company's Short-Term Debt.

In April 2002, the Company issued $81 million in face value of Long-Term Debt through Sequoia Mortgage Funding Company 2002-A, a trust established by Sequoia. This debt is collateralized by a pool of adjustable-rate residential mortgage securities. The proceeds received from this issuance were used to pay down a portion of the Company's Short-Term Debt.

In May 2002, the Company's Board of Directors declared a regular and special cash dividend for common shareholders of $0.63 per share and $0.125 per share, respectively, for the second quarter of 2002. The Board of Directors also declared a preferred cash dividend of $0.755 per share for the second quarter of 2002. The common and preferred cash dividends are payable on July 22, 2002 to shareholders of record on June 28, 2002.

In May 2002, the Company's common shareholders approved the Incentive Stock Plan and the 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP). The ESPP will allow eligible employees to purchase, through payroll deductions, shares of the Company's common stock on a quarterly basis at a discount rate from the fair market value of the shares as determined under the ESPP.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Consolidated Financial Statements and Notes.

SAFE HARBOR STATEMENT

"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995: Certain matters discussed in this Form 10-Q may constitute forward-looking statements within the meaning of the federal securities laws that inherently include certain risks and uncertainties. Throughout this Form 10-Q and other Company documents, the words "believe", "expect", "anticipate", "intend", "aim", "will", and similar words identify "forward-looking" statements. Actual results and the timing of certain events could differ materially from those projected in, or contemplated by, the forward-looking statements due to a number of factors, including, among other things, changes in interest rates and market values on our earning assets and borrowings, changes in prepayment rates on our mortgage assets, general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers, and the level of liquidity in the capital markets as it affects our ability to finance our mortgage asset portfolio, and other risk factors outlined in our Annual Report on Form 10-K for the year ended December 31, 2001. Other factors not presently identified may also cause actual results to differ. Future results and changes in expectations of future results could lead to adverse changes in our dividend rate. We continuously update and revise our estimates based on actual conditions experienced. We generally do not intend to publish such revisions. No one should assume that results projected in or contemplated by the forward-looking statements included herein will prove to be accurate in the future.

This Form 10-Q contains statistics and other data that in some cases have been obtained from, or compiled from, information made available by servicing entities and information service providers. In addition, some of the historical presentations contained herein have been restated to conform to current formats.

RESULTS OF OPERATIONS

Earnings and Dividend Summary and Outlook

In the first quarter of 2002, we increased our equity base through a common stock offering, improved our operating efficiencies, and further strengthened our balance sheet. As in 2001, our credit results remained excellent and we continued to increase our market share, gain new customers, and strengthen our competitive position. This growth in our high-quality residential business continued to drive our profitability.

Core earnings were $0.77 per share for the first quarter of 2002, an increase of 5% over first quarter 2001 core earnings of $0.73 per share. Core earnings were $0.76 per share in the fourth quarter 2001. Core earnings equal GAAP earnings excluding mark-to-market adjustments and non-recurring items. GAAP earnings for the first quarter of 2002 were $0.80 per share. See Table 1 for a reconciliation of GAAP earnings and core earnings.

After falling during most of 2001, short-term interest rates stabilized in the first quarter of 2002. The yield on our assets continued to fall during this period as the coupons reset to lower levels than existed at the prior resets. Our cost of funds also decreased for similar reasons. Our asset yield fell 0.49% (from 5.41% to 4.92%) from the previous quarter while our cost of funds decreased 0.74% (from 3.56% to 2.82%) and our interest rate spread increased to 2.10% from 1.85%.

Our spread increased as we continued to replace lower-yielding AAA-rated mortgage securities with higher-yielding mortgage loans and credit-enhancement securities. We believe this change in portfolio mix will continue in 2002 and will provide long-term benefits.

Our core net income for the first quarter of 2002 was $10.9 million, an increase of 66% from the $6.6 million we earned in the first quarter of 2001. Our annualized core return on common equity was 13.8% in the first quarter of 2002 and 13.8% in the first quarter of 2001. Our reported GAAP net income for the first quarter of 2002 was $11.2 million, an increase of 67% from the $6.7 million we earned in the first quarter of 2001.

As a result of an increase in our estimate of the reasonably sustainable rate of cash flow generation per share we expect in the future, we increased our regular quarterly cash dividend rate to $0.62 per common share in the first quarter of 2002 and to $0.63 per common share in the second quarter of 2002.

We believe we will continue to have a strong operating performance year in 2002; we currently expect to benefit from healthy origination volume by our customers, asset growth, improvements in asset mix, improved operational efficiencies, and favorable credit results.

Many market participants expect short-term interest rates to rise later in 2002. Relative to our earnings potential during a period of stable interest rates, rising interest rates may have both positive and negative effects on our earnings trends. A rapid or unexpected increase would be a negative factor for several quarters. Over longer periods of time, we believe higher interest rates are generally favorable for our business.

Our first goal in managing Redwood Trust's operations is to do our best to make sure that our regular dividend rate for common shareholders remains sustainable in the long run from the cash flows generated by our assets. We believe the current regular quarterly dividend rate of $0.63 per common share is a sustainable rate, even — in most circumstances — if some business trends become less favorable or interest rates increase.

In the event we earn taxable REIT income in excess of the dividends we distribute at our regular dividend rate we may declare one or more special dividends during 2002. We declared a special dividend of $0.125 per common share in the second quarter of 2002.

We believe the longer-term trends that really matter are the strength of our credit results and the strength of our competitive market position. If these stay strong, we may be able to increase our cash flows and increase our regular dividend rate over time.

Reconciliation of GAAP Income and Core Income

The table below reconciles core earnings to reported GAAP earnings. RWT Holdings, Inc. (Holdings) was an unconsolidated subsidiary through January 1, 2001. The table below shows Holdings on an as-if-consolidated basis for 2000.

Table 1

Core Earnings and GAAP Earnings
(Presented as if Holdings was consolidated in all periods)
(all dollars in thousands)

	Core Earnings	Asset Mark-to-Market Adjustments	Variable Stock Option Mark-to-Market Adjustments	Closed Business Units	Reported GAAP Earnings	Average Diluted Shares	Core Earnings Per Share	Reported GAAP Earnings Per Share
Q1: 2001	$ 6,563	$ 273	$ (156)	$ 0	$ 6,680	9,065,221	$ 0.73	$ 0.74
Q2: 2001	7,384	(413)	(508)	0	6,463	9,184,195	0.80	0.70
Q3: 2001	8,188	104	(227)	0	8,065	10,752,062	0.76	0.75
Q4: 2001	9,775	(800)	(20)	0	8,955	12,888,420	0.76	0.69
Q1: 2002	10,887	875	(543)	0	11,219	14,077,405	0.77	0.80
2000	$18,585	$ (2,329)	$ 0	$ (46)	$16,210	8,902,069	$ 2.08	$ 1.82
2001	31,910	(836)	(911)	0	30,163	10,474,764	3.05	2.88

Core earnings is not a measure of earnings in accordance with generally accepted accounting principles (GAAP). It is calculated as GAAP earnings from ongoing operations less mark-to-market adjustments (on certain assets, hedges, and variable stock options) and non-recurring items. Management believes that core earnings provide relevant and useful information regarding our results of operations in addition to GAAP measures of performance. This is, in part, because market valuation adjustments on only a portion of our assets and stock options and none of our liabilities are recognized through our income statement under GAAP and

these valuation adjustments may not be fully indicative of changes in market values on our balance sheet or a reliable guide to our current or future operating performance. Furthermore, gains or losses realized upon sales of assets and operating results of closed business units are generally non-recurring and any non-recurring items may also be unrepresentative of our current or future operating performance. Because all companies and analysts do not calculate non-GAAP measures such as core earnings in the same fashion, core earnings as calculated by us may not be comparable to similarly titled measures reported by other companies.

Net Interest Income

Net interest income after credit expenses rose to $15.1 million in the first quarter of 2002 from $13.2 million in the fourth quarter of 2001 and $10.2 million in the first quarter of 2001. We benefited from our continuing strategy of growth in our high-quality jumbo residential mortgage loan business, a business where we believe we have a solid competitive position and favorable long-term market trends. We also benefited from a change in asset mix as we added higher yielding assets.

Table 2

Net Interest Income After Credit Expenses
(all dollars in thousands)

	Interest Income After Credit Expenses	Interest Expense	Net Interest Income After Credit Expenses	Earning Asset Yield	Cost Of Funds	Interest Rate Spread After Credit Expenses	Interest Rate Margin After Credit Expenses	Net Interest Income/ Average Equity
Q1: 2001	$ 41,637	$ (31,413)	$10,224	7.72%	6.34%	1.38%	1.85%	18.83%
Q2: 2001	38,453	(27,010)	11,443	7.18%	5.45%	1.73%	2.06%	20.76%
Q3: 2001	33,172	(21,555)	11,617	6.63%	4.83%	1.80%	2.24%	18.25%
Q4: 2001	31,277	(18,091)	13,186	5.41%	3.56%	1.85%	2.22%	17.40%
Q1: 2002	30,716	(15,602)	15,114	4.92%	2.82%	2.10%	2.36%	17.69%
2000	$169,261	$(138,603)	$30,658	7.56%	6.69%	0.87%	1.33%	14.33%
2001	144,539	(98,069)	46,470	6.71%	5.04%	1.67%	2.09%	18.66%

Redwood’s primary source of debt funding is the issuance of non-recourse long-term collateralized debt through securitization transactions. Collateral assets are transferred to a special-purpose bankruptcy-remote financing trust and non-recourse securities are issued from the trust. These transactions are accounted for as financings. Thus, the securitized assets remain on our reported balance sheet (residential mortgage loans) and the securities issued remain on our balance sheet as liabilities (long-term debt).

If our securitizations had qualified as sales, our reported balance sheet (both assets and liabilities) would be substantially smaller. As a result, many of the ratios one might use to analyze our business would be different. For instance, our interest rate spread would be wider and our debt-to-equity ratio lower. Ratios calculated on this basis may be more comparable to those reported by some other financial institutions. The table below presents our interest income and interest expense on an “at-risk” basis for assets and on a recourse basis for liabilities (generally, conforming to the income statement items we would report if we accounted for our securitizations as sales rather than financings). Please also see the discussion under “Balance Sheet Leverage” below for further information.

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Table 3

Income on "At-Risk" Assets and Recourse Liabilities Basis
(all dollars in thousands)

	Total Interest Income After Credit Expenses	Interest Expenses	Net Interest Income After Credit Expenses	Earning Asset Yield	Cost Of Funds	Interest Rate Spread After Credit Expenses	Interest Rate Margin After Credit Expenses	Net Interest Income/ Average Equity
Q1: 2001	$ 23,799	$(13,575)	$10,224	8.51%	5.96%	2.55%	3.60%	18.83%
Q2: 2001	23,286	(11,843)	11,443	7.99%	4.91%	3.08%	3.83%	20.76%
Q3: 2001	20,458	(8,841)	11,617	7.43%	4.15%	3.28%	4.11%	18.25%
Q4: 2001	19,328	(6,142)	13,186	6.70%	2.93%	3.77%	4.49%	17.40%
Q1: 2002	20,055	(4,941)	15,114	6.30%	2.12%	4.18%	4.75%	17.69%
2000	$ 92,967	$(62,309)	$30,658	8.63%	6.67%	1.96%	2.76%	14.33%
2001	86,871	(40,401)	46,470	7.66%	4.53%	3.13%	4.01%	18.66%

Interest Income After Credit Expenses

Our interest income continued to decrease due to a significant decline in asset yields caused by rapidly falling short-term interest rates during 2001. The decrease in our interest income and asset yields has not resulted in a material reduction of our operating margins, however, as this decline in asset yield has been fully offset by a similar rapid decrease in our cost of borrowed funds.

The yield on our earning assets, the majority of which are adjustable-rate residential mortgage loans, fell from 7.72% in the first quarter of 2001 to 5.41% in the fourth quarter of 2001 and to 4.92% in the first quarter of 2002.

Table 4

Total Interest Income and Yields
(all dollars in thousands)

	Average Earning Assets	Interest Income	Net Premium Amortization Expense	Credit Provision Expense	Total Interest Income	Earning Asset Yield
Q1: 2001	$2,156,741	$ 42,690	$ (869)	$ (184)	$ 41,637	7.72%
Q2: 2001	2,142,496	40,502	(1,885)	(164)	38,453	7.18%
Q3: 2001	2,001,687	35,300	(1,977)	(151)	33,172	6.63%
Q4: 2001	2,310,906	36,399	(4,854)	(268)	31,277	5.41%
Q1: 2002	2,498,565	33,977	(2,979)	(282)	30,716	4.92%
2000	$2,237,956	$172,327	$ (2,335)	$ (731)	$169,261	7.56%
2001	2,152,965	154,891	(9,585)	(767)	144,539	6.71%

To provide a greater level of detail on our interest income trends, we review interest income by product line below. Each of our product lines is a component of our single business segment of real estate finance.

Residential Mortgage Loans

Our residential mortgage loan portfolio increased 22% in the first quarter of 2002 to $1.8 billion. We acquired $417 million residential mortgage loans during the first quarter of 2002. These acquisitions were all adjustable

rate loans. We plan to continue to expand our customer base and increase our acquisitions of high-quality jumbo residential mortgage loans throughout 2002.

Table 5

Residential Mortgage Loans — Activity
(all dollars in thousands)

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Start of Period Balances	$1,474,862	$1,354,606	$1,060,470	$1,071,819	$1,130,997
Acquisitions	417,276	207,170	391,328	76,314	0
Sales	0	0	0	0	0
Principal Payments	(95,924)	(82,676)	(96,172)	(86,511)	(58,539)
Amortization	(1,672)	(3,991)	(1,180)	(1,065)	(485)
Credit Provisions	(282)	(268)	(151)	(164)	(184)
Net Charge-Offs	0	29	311	12	30
Mark-To-Market (Balance Sheet)	0	0	0	0	0
Mark-To-Market (Income Statement)	0	(8)	0	65	0
End of Period Balances	$1,794,260	$1,474,862	$1,354,606	$1,060,470	$1,071,819

Most of our residential loans have coupon rates that adjust each month or each six months as a function of the one or six month LIBOR interest rate. Due to the rapid decline in these interest rates during 2001, the yield on our residential loan portfolio fell from 7.21% in the first quarter of 2001 and to 4.00% in the fourth quarter of 2001 to 3.66% in the first quarter of 2002.

Table 6

Residential Mortgage Loans — Interest Income and Yields
(all dollars in thousands)

	Average Principal Balance	Average Net Premium Balance	Average Credit Reserve	Annual Mortgage Prepay Rate (CPR)	Interest Income	Net Premium Amortization Expense	Credit Provision Expense	Total Interest Income	Yield
Q1: 2001	$1,083,943	$13,519	$(4,895)	21%	$20,371	$ (485)	$ (184)	$19,702	7.21%
Q2: 2001	1,007,227	12,747	(5,051)	24%	17,492	(1,065)	(164)	16,263	6.41%
Q3: 2001	1,087,593	12,138	(4,950)	25%	16,583	(1,180)	(151)	15,252	5.57%
Q4: 2001	1,372,552	12,023	(5,065)	19%	18,053	(3,990)	(268)	13,795	4.00%
Q1: 2002	1,541,136	9,130	(5,342)	18%	16,079	(1,672)	(282)	14,125	3.66%
2000	$1,238,993	$15,080	$(4,408)	17%	$93,460	$ (2,595)	$ (731)	$90,134	7.21%
2001	1,138,482	12,646	(4,991)	22%	72,499	(6,720)	(767)	65,012	5.67%

Credit results remain excellent for our residential mortgage loan portfolio. We had no credit losses in the first quarter of 2002. At March 31, 2002, our residential mortgage loan credit reserve was $5.5 million, equal to 0.31% of the current balance of this portfolio. Credit provision expense has increased in recent quarters due to the significant acquisitions of residential mortgage loans.

Our residential loan delinquencies declined from $5.1 million at the beginning of the year to $4.9 million at the end of the first quarter of 2002. Delinquencies include loans delinquent more than 90 days, in bankruptcy, in foreclosure, and real estate owned. As a percentage of our loan portfolio, delinquencies declined from 0.34% to 0.27% during this period. This decline in delinquency percentage is primarily due to the significant amount of recently originated whole loans acquired in the first quarter. Delinquencies and credit losses may rise in the near future as a result of a weak economy and seasoning of the loans in our portfolio.

Table 7

Residential Mortgage Loans — Credit Results
(at period end, all dollars in thousands)

	Ending Balance	Delinquent Loans	Delinquent Loan %	Loss Severity On Liquidated Loans	Realized Credit Losses	Annualized Credit Losses As % of Loans	Ending Credit Reserve
Q1: 2001	$1,071,819	$ 6,371	0.59%	13%	(30)	0.01%	$4,968
Q2: 2001	1,060,470	4,913	0.46%	14%	(12)	0.01%	5,120
Q3: 2001	1,354,606	4,823	0.36%	60%	(311)	0.09%	4,960
Q4: 2001	1,474,862	5,069	0.34%	39%	(29)	0.01%	5,199
Q1: 2002	1,794,260	4,926	0.27%	0%	0	0.00%	5,481
2000	$1,130,997	$ 5,667	0.50%	9%	(42)	0.01%	$4,814
2001	1,474,862	5,069	0.34%	42%	(382)	0.03%	5,199

The characteristics of our loans continue to show the high-quality nature of our residential mortgage loan portfolio. At March 31, 2002, we owned 4,914 residential loans with a total value of $1.8 billion. These were all "A" quality loans at origination. All these loans were adjustable rate loans. Our average loan size was $364,360. Northern California loans were 12% of the total and Southern California loans were 11% of the total. Loans originated in 1999 or earlier were 41% of the total. On average, our residential mortgage loans had 25 months of seasoning. Loans where the original loan balance exceeded 80% loan-to-value (LTV) made up 28% of loan balances; we benefit from mortgage insurance or additional pledged collateral on all of these loans, serving to substantially lower the effective LTV on these loans. The average effective LTV at origination for our mortgage loans (including the effect of mortgage insurance, pledged collateral, and other credit enhancements) was 67%. Given housing appreciation and loan amortization, we estimated the current effective LTV of our residential mortgage loans was roughly 61%.

Table 8

Residential Mortgage Loans — Loan Characteristics
(all dollars in thousands)

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Principal Value (Face Value)	$1,790,239	$1,470,467	$1,346,346	$1,053,158	$1,063,633
Internal Credit Reserves	(5,481)	(5,199)	(4,960)	(5,120)	(4,968)
Premium (Discount) to be Amortized	9,502	9,594	13,220	12,432	13,154
Retained Residential Loans	$1,794,260	$1,474,862	$1,354,606	$1,060,470	$1,071,819
Number of loans	4,914	4,177	3,909	3,306	3,433
Average loan size	$ 364	$ 353	$ 347	$ 321	$ 312
Adjustable %	100%	100%	81%	73%	71%
Hybrid %	0%	0%	19%	27%	29%
Fixed %	0%	0%	0%	0%	0%
Northern California	12%	10%	10%	13%	13%
Southern California	11%	12%	12%	10%	11%
Florida	12%	11%	11%	9%	9%
New York	7%	8%	8%	9%	8%
Georgia	7%	8%	7%	4%	5%
New Jersey	5%	5%	5%	6%	5%
Texas	4%	4%	5%	5%	5%
Other states	42%	42%	42%	44%	44%
Year 2002 origination	17%	0%	0%	0%	0%
Year 2001 origination	42%	45%	34%	7%	0%
Year 2000 origination	0%	0%	0%	0%	0%
Year 1999 origination	9%	11%	12%	17%	18%
Year 1998 origination or earlier	32%	44%	54%	76%	82%
% balance in loans> $1mm per loan	16%	15%	14%	11%	11%

We intend to fund our mortgage loans through the issuance of long-term debt through our special purpose subsidiary, Sequoia Mortgage Funding Corporation (Sequoia). This type of financing is non-recourse to Redwood Trust. Our exposure to our $1.2 billion of long-term financed loans is limited to our investment in Sequoia, which at March 31, 2002 was $28.4 million or 2.3% of the Sequoia loan balances. Short-term funded residential mortgage loans at March 31, 2002 were $0.6 billion. We intend to permanently fund all of our residential loans with the non-recourse long-term Sequoia debt that we issue from time to time. In April 2002, we issued $502 million of long-term debt to replace the short-term debt related to $514 million of residential mortgage loans.

Residential Credit-Enhancement Securities

At March 31 2002, we owned $250 million of residential credit-enhancement securities, an increase of 31% over the $191 million we owned at December 31, 2001. These securities had below-investment-grade credit ratings and represented subordinated interests in pools of high-quality jumbo residential mortgage loans. We continue to increase our capacity to evaluate and acquire these assets and to strengthen our relationships with the sellers and servicers of these assets. At the same time, the volume of newly originated and seasoned loans

undergoing securitization and available for purchase increased. We expect to continue to acquire residential credit-enhancement securities throughout 2002.

Table 9

Residential Credit-Enhancement Securities — Activity
(all dollars in thousands)

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Start of Period Balances	$190,813	$188,283	$158,704	$100,849	$ 80,764
Acquisitions	59,157	17,132	27,172	61,195	20,695
Sales	(5,037)	(7,786)	0	(1,780)	0
Principal Payments	(4,270)	(3,857)	(1,895)	(1,952)	(1,022)
Amortization	366	(92)	86	161	126
Mark-To-Market (Balance Sheet)	8,758	(3,258)	4,216	223	2,654
Mark-To-Market (Income Statement)	45	391	0	8	(2,368)
End of Period Balances	$249,832	$190,813	$188,283	$158,704	$100,849

Our residential credit-enhancement securities are first-loss, second-loss, or third loss interests. First loss interests are generally allocated actual credit losses on the entire underlying pool of loans up to a maximum of the principal amount of the first loss interest. Our ownership of first loss interests provides credit-enhancement principal protection from the initial losses in the underlying pool for the second loss, third loss, and more senior interests. Any first loss interests that are owned by others and that are junior to our second and third loss interests provide our interests with some principal protection from losses (they serve as external credit-enhancement).

At March 31, 2002, we owned $460 million principal (face) value of residential credit-enhancement securities at a cost basis of $237 million. After mark-to-market adjustments, our net investment in these assets, as reflected on our balance sheet, was $250 million. Over the life of the underlying mortgage loans, we expect to receive principal payments from these securities of $460 million less credit losses. We receive interest payments each month on the outstanding principal amount. Of the $210 million difference between principal value and reported value, $195 million was designated as an internal credit reserve (reflecting our estimate of future credit losses over the life of the underlying mortgages), $28 million was designated as purchase discount to be amortized into income over time, and $13 million represented positive balance sheet market valuation adjustments.

Table 10

Residential Credit-Enhancement Securities — Net Book Value
(all dollars in thousands)

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Total principal value (face value)	$ 460,035	$ 353,435	$ 323,870	$266,004	$155,233
Internal credit reserves	(194,556)	(140,411)	(112,133)	(78,170)	(35,722)
Discount to be amortized	(28,058)	(25,863)	(30,365)	(31,824)	(21,137)
Net investment	237,421	187,161	181,372	156,010	98,374
Market valuation adjustments	12,411	3,652	6,911	2,694	2,475
Net book value	$ 249,832	$ 190,813	$ 188,283	$158,704	$100,849
First loss position, principal value	$ 173,990	$ 129,019	$ 105,830	$ 76,386	$ 41,156
Second loss position, principal value	127,930	96,567	84,876	67,700	37,197
Third loss position, principal value	158,115	127,849	133,164	121,918	76,880
Total principal value	$ 460,035	$ 353,435	$ 323,870	$266,004	$155,233
First loss position, net book value	$ 42,760	$ 29,648	$ 25,886	$ 18,956	$ 13,191
Second loss position, net book value	79,969	60,074	53,925	43,733	25,106
Third loss position, net book value	127,103	101,091	108,472	96,015	62,552
Total net book value	$ 249,832	$ 190,813	$ 188,283	$158,704	$100,849

Total interest income from our residential credit-enhancement securities increased to $6.7 million in the first quarter of 2002 from $5.4 million in the fourth quarter of 2001 and $2.6 million in the first quarter of 2001. An increase in our net investment in these securities was the principal reason for the increases in interest income.

Our credit-enhancement portfolio yield was 13.29% during the first quarter of 2002, an increase from 12.01% in the fourth quarter 2001 and 12.32% in the first quarter of 2001. Yields have been increasing over the past several quarters due to the acquisition of an increased proportion of first and second loss interests which have higher yields than third loss interests due to their higher risk levels. In addition, some of our securities have improved yields as a result of faster than anticipated prepayment speeds and/or better than expected credit performance.

Under the effective yield method, credit losses lower than (or later than) anticipated by our designated credit reserve and/or faster than anticipated long-term prepayment rates could result in increasing yields being recognized from our current portfolio. Credit losses higher than (or earlier than) anticipated by our designated credit reserve and/or slower than anticipated long-term prepayment rates could result in lower yields being recognized under the effective yield method and/or market value adjustments through our income statement under EITF 99-20. Yield and EITF 99-20 adjustments are on an asset-specific basis.

Table 11

Residential Credit-Enhancement Securities — Interest Income and Yields
(all dollars in thousands)

	Average Principal Value	Average Credit Reserve	Average Net Discount Balance	Average Basis	Coupon Income	Net Discount Amortization Income	Total Interest Income	Yield
Q1: 2001	$135,471	$ (31,415)	$(18,260)	$ 85,796	$ 2,516	$ 126	$ 2,642	12.32%
Q2: 2001	184,472	(48,845)	(21,920)	113,707	3,242	161	3,403	11.97%
Q3: 2001	296,417	(96,364)	(31,378)	168,675	5,160	86	5,246	12.44%
Q4: 2001	328,652	(121,183)	(27,914)	179,555	5,484	(92)	5,392	12.01%
Q1: 2002	389,798	(164,995)	(23,263)	201,540	6,329	366	6,695	13.29%
2000	$ 87,070	$ (18,527)	$ (9,734)	$ 58,809	$ 6,532	$ 1,992	$ 8,524	14.49%
2001	236,947	(74,763)	(24,907)	137,276	16,402	281	16,683	12.15%

Credit losses for the $65 billion portfolio that we credit enhanced at March 31, 2002 totaled $0.5 million in the first quarter of 2002. The annualized rate of credit loss was less than 1 basis point (0.01%) of the portfolio. Of this loss, $0.6 million was borne by the external credit enhancements to our positions and we had net recoveries of $0.1 million on our interests.

Delinquencies (over 90 days, foreclosure, bankruptcy, and REO) in our credit-enhancement portfolio decreased from 0.24% of the current balances at the end of 2001 to 0.20% at the end of the first quarter of 2002. We expect delinquency and loss rates for our existing residential credit-enhancement securities to increase from their current modest levels, given a weaker economy and the natural seasoning pattern of these loans. However, in periods where we have significant increases in the size of our portfolio, total delinquencies as a percent of the pool balance may decline (as occurred in the first quarter of 2002).

Table 12

Residential Credit-Enhancement Securities — Credit Results
(at period end, all dollars in thousands)

	Underlying Mortgage Loans	Delinquencies		Redwood's Share of Net Credit Losses	Losses To External Credit Enhancement	Total Credit Losses	Total Credit Losses as % of Loans (annualized)
		$	%				
Q1: 2001	$27,081,361	$ 63,893	0.24%	$ (55)	$ (550)	$ (605)	0.01%
Q2: 2001	38,278,631	98,287	0.26%	(196)	(824)	(1,020)	0.01%
Q3: 2001	49,977,641	107,821	0.22%	(192)	(407)	(599)	0.01%
Q4: 2001	51,720,856	124,812	0.24%	(321)	(571)	(892)	0.01%
Q1: 2002	64,826,605	129,849	0.20%	166	(618)	(452)	0.01%
2000	$22,633,860	$ 51,709	0.23%	$ (758)	$ (3,750)	$(4,508)	0.02%
2001	51,720,856	124,812	0.24%	(764)	(2,352)	(3,116)	0.01%

At March 2002, we had $80 million of external credit enhancements and $195 million of internal credit reserves for this portfolio. External credit reserves serve to protect us from credit losses on a specific asset basis and represent the principal value of interests that are junior to us and are owned by others. Total reserves of $275 million represented 42 basis points (0.42%) of our credit-enhancement portfolio of $65 billion. Reserves, credit protection, and risks are specific to each credit-enhancement interest.

Table 13

Residential Credit-Enhancement Securities — Credit Protection
(at period end, all dollars in thousands)

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Internal Credit Reserves	$194,556	$140,411	$112,133	$ 78,170	$ 35,722
External Credit Enhancement	79,924	90,224	94,745	91,004	86,600
Total Credit Protection	$274,480	$230,635	$206,878	$169,174	$122,322
As % of Total Portfolio	0.42%	0.45%	0.41%	0.44%	0.45%

The characteristics of the loans that we credit-enhance continue to show their high-quality nature. At March 31, 2002, we credit enhanced 162,502 loans in our total credit-enhancement portfolio. Of the $65 billion loan balances, 67% were fixed-rate loans, 14% were hybrid loans (loans that become adjustable 3 to 10 years after origination), and 19% were adjustable-rate loans. The average size of the loans that we credit-enhanced was $398,900. We credit-enhanced 1,992 loans with principal balances in excess of $1 million; these loans had an average size of $1.4 million and a total loan balance of $2.8 billion. Loans over $1 million were 1% of the total number of loans and 4% of the total balance of loans that we credit-enhanced at quarter-end.

The average FICO score of borrowers on residential mortgage loans underlying our residential credit-enhancement securities where FICO was obtained was 728. Borrowers with FICO scores over 720 comprised 60% of the portfolio, those with scores between 680 and 720 comprised 23%, those with scores between 620 and 680 comprised 15% and those with scores below 620 comprised 2%. In general, loans with lower FICO scores have strong compensating factors.

Many of the loans that we credit enhance are seasoned. On average, our credit-enhanced loans had 23 months of seasoning. Generally, the credit risk for seasoned loans is reduced as property values appreciate and the loan balances amortize. The current LTV ratio for seasoned loans is often much reduced from the LTV ratio at origination.

Loans with LTV's at origination in excess of 80% made up 7% of loan balances. We benefit from mortgage insurance or additional pledged collateral on 99% of these loans, serving to substantially reduce the effective LTV on these loans. The average effective LTV at origination for all the loans we credit enhance (including the effect of mortgage insurance, pledged collateral, and other credit enhancements) was 70%. Given housing appreciation and loan amortization, we estimated the average current effective LTV for these loans was roughly 63%.

Table 14

**Residential Credit-Enhancement Securities — Underlying Collateral Characteristics
(all dollars in thousands)**

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Credit-enhancement securities	$64,826,605	$51,720,856	$49,977,641	$38,278,631	$27,081,361
Number of credit-enhanced loans	162,502	133,634	132,555	105,721	77,011
Average loan size	$ 398	$ 387	$ 377	$ 362	$ 352
Adjustable %	19%	15%	11%	19%	28%
Hybrid %	14%	17%	19%	20%	11%
Fixed %	67%	68%	70%	61%	61%
Northern California	25%	27%	25%	26%	23%
Southern California	25%	26%	26%	28%	24%
New York	5%	5%	5%	5%	6%
Texas	4%	4%	4%	3%	4%
New Jersey	3%	3%	3%	3%	4%
Virginia	3%	3%	3%	3%	3%
Other states	35%	32%	34%	32%	36%
Year 2002 origination	1%	0%	0%	0%	0%
Year 2001 origination	55%	43%	32%	21%	7%
Year 2000 origination	8%	10%	14%	14%	21%
Year 1999 origination	17%	22%	31%	36%	29%
Year 1998 or earlier origination	19%	25%	23%	29%	43%
% balance in loans> $1mm per loan	4%	4%	3%	4%	6%

The geographic dispersion of our credit-enhancement portfolio generally mirrors that of the jumbo residential market as a whole with approximately half of our loans concentrated in California.

For the loans that we credit enhanced where the home was located in Northern California (25% of the total portfolio), at March 31, 2002 the average loan balance was $421,400, the average FICO score was 730, and the average LTV at origination was 68%. On average, these Northern California loans had 24 months of seasoning, with 1% originated in year 2002, 57% in year 2001, 5% in year 2000, and 37% in years 1999 or earlier. At March 31, 2002, 628 of these loans had principal balances in excess of $1 million; these larger loans had an average size of $1.4 million and a total loan balance of $879 million. They represented 1% of the total number of Northern California loans and 5% of the total balance of Northern California loans. Delinquencies in our Northern California residential credit-enhancement portfolio at March 31, 2002 were 0.14% of current loan balances.

For the loans that we credit enhanced where the home was located in Southern California (25% of the total portfolio), at March 31, 2002 the average loan balance was $410,800, the average FICO score was 725, and the average LTV at origination was 71%. On average, these Southern California loans had 32 months of seasoning, with 1% originated in year 2002, 46% in year 2001, 5% in year 2000, and 48% in years 1999 or earlier. At March 31, 2002, 643 of these loans had principal balances in excess of $1 million; these larger loans had an average size of $1.4 million and a total loan balance of $923 million. They represented 2% of the total number of Southern California loans and 6% of the total balance of Southern California loans. Delinquencies

in our Southern California residential credit-enhancement portfolio at March 31, 2002 were 0.28% of current loan balances.

Combined Residential Loan Portfolios

The table below summarizes the credit protection of our residential mortgage loans and our residential credit-enhancement securities on a combined basis.

Table 15

Residential Portfolios — Credit Protection
(all dollars in thousands)

	Total Residential Loans	Redwood's Residential Credit Reserve	External Credit Enhancement	Total Credit Protection	Total Credit Protection As % of Loans
Q1: 2001	$28,153,180	$ 40,690	$ 86,600	$127,290	0.45%
Q2: 2001	39,339,101	83,290	91,004	174,294	0.44%
Q3: 2001	51,332,247	117,093	94,745	211,838	0.41%
Q4: 2001	53,195,718	145,610	90,224	235,834	0.44%
Q1: 2002	66,620,865	200,037	79,924	279,961	0.42%
2000	$23,764,857	$ 31,866	$ 86,840	$118,706	0.50%
2001	53,195,718	145,610	90,224	235,834	0.44%

The table below summarizes the credit performance of our residential mortgage loans and our residential credit-enhancement securities on a combined basis.

Table 16

Residential Portfolios — Credit Performance
(all dollars in thousands)

	Delinquencies	Delinquencies As % of Total Residential Loans	Redwood's Share of Net Credit (Losses) Recoveries	Losses To External Credit Enhancement	Total Credit Losses	Total Credit Losses as % of Loans (annualized)
Q1: 2001	$ 70,264	0.25%	$ (85)	$ (550)	$ (635)	0.01%
Q2: 2001	103,200	0.26%	(208)	(824)	(1,032)	0.01%
Q3: 2001	112,644	0.22%	(503)	(407)	(910)	0.01%
Q4: 2001	129,881	0.24%	(352)	(571)	(923)	0.01%
Q1: 2002	134,775	0.20%	166	(618)	(452)	0.01%
2000	$ 57,376	0.24%	$ (799)	$ (3,751)	$(4,550)	0.02%
2001	129,881	0.24%	(1,148)	(2,352)	(3,500)	0.01%

Commercial Mortgage Loans

Our commercial real estate loan portfolio decreased to $49 million at March 31, 2002 due to loan payoffs and sales over the past several quarters. We plan to acquire commercial loans and commercial loan participations later in 2002.

Table 17

Commercial Mortgage Loans — Activity
(all dollars in thousands)

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Start of Period Balances	$51,084	$ 64,362	$67,043	$70,077	$76,082
Acquisitions	140	210	0	1,500	0
Sales	0	0	(2,645)	(3,573)	(1,513)
Principal Payments	(1,873)	(13,403)	(44)	(897)	(4,572)
Amortization	28	29	15	104	76
Mark-To-Market (Balance Sheet)	0	0	0	0	0
Mark-To-Market (Income Statement)	1	(114)	(7)	(168)	4
End of Period Balances	$49,380	$ 51,084	$64,362	$67,043	$70,077

The yield on our commercial mortgage loans decreased in the first quarter of 2002 due to a reduction in fees recognized at the time of loan payoff. Early payoffs resulted in the acceleration of the recognition of deferred origination fees, prepayment penalty, and exit fees. All commercial mortgage loans in our portfolio had interest rate floors, so the decline in short-term interest rates over the past year did not have a material impact on the yields on these loans.

Table 18

Commercial Mortgage Loans — Interest Income and Yields
(all dollars in thousands)

	Average Principal Value	Average Net Discount Balance	Coupon Income	Discount Amortization Income	Credit Provision Expense	Total Interest Income	Yield
Q1: 2001	$73,836	$(1,208)	$1,857	$ 76	$ 0	$1,933	10.65%
Q2: 2001	70,279	(878)	1,857	104	0	1,961	11.30%
Q3: 2001	66,024	(724)	1,680	15	0	1,695	10.38%
Q4: 2001	64,851	(601)	1,862	29	0	1,891	11.77%
Q1: 2002	50,872	(702)	1,247	27	0	1,274	10.15%
2000*	$53,127	$(1,116)	$5,260	$ 822	$ 0	$6,082	11.69%
2001	68,715	(851)	7,256	224	0	7,480	11.02%

*Includes loans held at RWT Holdings, Inc., which was consolidated with our financials as of January 1, 2001.

To date, we have not experienced delinquencies or credit losses in our commercial mortgage loans nor have we established a credit reserve for our commercial loans. A slowing economy, and factors particular to each loan, could cause credit concerns and issues in the future. If this occurs, we may need to provide for future losses or reduce the reported market value for commercial mortgage loans held for sale. Other factors may also affect the market value of these loans.

Table 19

Commercial Mortgage Loans — Characteristics
(all dollars in thousands)

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Commercial Mortgage Loans	$49,380	$51,084	$64,362	$67,043	$70,077
Number of Loans	7	8	14	16	18
Average Loan Size	$ 7,054	$ 6,386	$ 4,597	$ 4,190	$ 3,893
Serious Delinquency $	$ 0	$ 0	$ 0	$ 0	$ 0
Realized Credit losses	$ 0	$ 0	$ 0	$ 0	$ 0
California %	61%	59%	67%	68%	71%

Our goal is to secure long-term non-recourse debt for our commercial mortgage loans. In March 2002, we issued $8 million of long-term debt collateralized debt for our commercial real estate loans. At March 31, 2002, three of our commercial loans, totaling over $30 million of principal, were financed through long-term debt in the form of commercial loan participations. Our remaining commercial mortgage loans were financed with a combination of equity and short- and medium-term credit facilities.

Securities Portfolio

Our securities portfolio consisted of all the securities we owned with the exception of residential credit-enhancement securities (discussed separately above). At March 31, 2002, our securities portfolio consisted primarily of investment-grade residential mortgage securities held to generate interest income. We will likely acquire lower-rated and more diverse securities in the future. During the first quarter of 2002, this portfolio decreased from $683 million to $609 million. As a part of our long-term strategy, we plan to reduce short-term debt utilized to fund our securities portfolio; we expect to either reduce the size of our securities and/or to fund these securities with long-term debt. In April 2002, we issued $81 million in face value of Long-Term Debt through Sequoia Mortgage Funding Company 2002-A, a trust established by Sequoia. This debt is collateralized by a pool of adjustable-rate residential mortgage securities. The proceeds received from this issuance were used to pay down a portion of the Company's Short-Term Debt.

Table 20

Securities Portfolio — Activity
(all dollars in thousands)

	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
Start of Period Balances	$683,482	$608,793	$ 739,187	$1,000,612	$ 764,775
Acquisitions	76,701	147,251	47,323	16,051	310,026
Sales	(89,395)	(15,260)	(106,297)	(162,753)	(11,000)
Principal Payments	(60,040)	(53,400)	(71,692)	(113,165)	(65,726)
Premium Amortization	(1,701)	(799)	(898)	(1,086)	(586)
Mark-To-Market (Balance Sheet)	(444)	(2,034)	1,087	(94)	(6)
Mark-To-Market (Income Statement)	829	(1,069)	83	(378)	3,129
End of Period Balances	$609,432	$683,482	$ 608,793	$ 739,187	$1,000,612

Total interest income from this portfolio was $8.5 million in the first quarter of 2002, a decrease from $9.9 million in the fourth quarter of 2001 and from $17.0 million in the first quarter of 2001. This decrease was the result of lower average balances and lower yields.

The yields on this portfolio have fallen over the past several quarters due to declining short-term interest rates, as the majority of these securities represent interests in pools of adjustable-rate residential mortgage loans. We expect adjustable coupon rates to continue to decrease for the next several months, even if interest rates

stabilize or rise. Actual and anticipated mortgage prepayment rates have been relatively high, further depressing yields due to the faster amortization of purchase premiums.

Table 21

Securities Portfolio — Interest Income Relativity and Yields
(all dollars in thousands)

	Average Earning Assets	Average Net Premium Balance	Mortgage Prepayment Rates (CPR)	Interest Income	Net Premium Amortization Expense	Total Interest Income	Yield
Q1: 2001	$874,307	$10,164	19%	$17,634	$ (586)	$17,048	7.71%
Q2: 2001	910,793	14,013	31%	17,648	(1,086)	16,562	7.16%
Q3: 2001	626,246	12,332	32%	11,642	(898)	10,744	6.73%
Q4: 2001	628,193	11,838	31%	10,702	(799)	9,903	6.19%
Q1: 2002	666,570	10,122	31%	10,215	(1,701)	8,514	5.03%
2000	$884,081	$ 8,475	20%	$68,982	$ (1,776)	$67,206	7.53%
2001	758,844	12,092	28%	57,626	(3,369)	54,257	7.04%

The table below presents our securities portfolio by asset type.

Table 22

Securities Portfolio — Characteristics
(Residential Mortgage Backed Securities, unless noted)
(all dollars in thousands)

	Credit Rating	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001	Mar. 2001
FNMA & FHLMC — Adjustable	"AAA"	$285,174	$353,523	$389,400	$434,732	$ 485,639
FNMA & FHLMC — Hybrid	"AAA"	0	20,223	0	2,828	3,096
Jumbo Prime — Adjustable	AAA or AA	157,279	144,813	138,261	243,078	451,950
Jumbo Prime — Hybrid	AAA or AA	133,456	137,926	43,775	0	0
Jumbo Prime — Fixed	AAA or AA	4,961	5,018	15,732	24,815	23,997
Subprime — Floaters	AAA or AA	20,935	14,600	14,600	14,600	19,277
Subprime — Fixed	AAA to BBB	0	600	1,050	13,026	13,062
Interest-Only — Residential	AAA	0	13	53	60	71
Interest-Only — Commercial	AAA	4,768	4,874	5,008	5,082	2,534
CBO Equity — Mixed Real Estate	B or NR	2,859	1,892	914	966	986
Total Securities Portfolio		$609,432	$683,482	$608,793	$739,187	$1,000,612
Realized Credit Losses During Quarter		$ 0	$ 0	$ 0	$ 0	$ 0

We owned fixed rate securities in our securities portfolio and our residential credit-enhancement securities portfolio, but not in amounts that materially exceed our equity capital base (see Table 30). We have generally avoided funding fixed rate assets with floating rate liabilities.

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Interest Expense

Our cost of borrowed funds has continued to fall over the past several quarters. During the first quarter of 2002, our cost of borrowed funds was 2.82%, a decrease from 3.56% in the fourth quarter of 2001 and 6.34% in the first quarter of 2001. This decline in interest expense of our adjustable-rate debt was due to the decrease in short-term interest rates in 2001 and the stabilization of short-term interest rates thus far in 2002. Our average debt levels rose slightly from $2.0 billion in the first quarter of 2001 to $2.2 billion in the first quarter of 2002. Due to the decline in borrowing costs, our interest expenses declined from $31.4 million in the first quarter of 2001 to $15.6 million in the first quarter of 2002.

Table 23

Interest Expense
(all dollars in thousands)

	Average Long Term Debt	Long Term Debt Interest Expense	Long Term Debt Cost of Funds	Average Short Term Debt	Short Term Debt Interest Expense	Short Term Debt Cost of Funds	Total Interest Expense	Total Cost Of Funds
Q1: 2001	$1,072,172	$17,838	6.65%	$910,515	$13,575	5.96%	$ 31,413	6.34%
Q2: 2001	1,018,646	15,167	5.96%	964,543	11,843	4.91%	27,010	5.45%
Q3: 2001	933,340	12,714	5.45%	852,341	8,841	4.15%	21,555	4.83%
Q4: 2001	1,193,050	11,949	4.01%	839,879	6,142	2.93%	18,091	3.56%
Q1: 2002	1,280,503	10,661	3.33%	931,424	4,941	2.12%	15,602	2.82%
2000	$1,137,324	$76,294	6.71%	$933,619	$62,309	6.67%	$138,603	6.69%
2001	1,054,135	57,668	5.47%	891,251	40,401	4.53%	98,069	5.04%

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The table below lists our long-term debt issuance.

Table 24

Long-Term Debt Characteristics
(all dollars in thousands)

Long Term Debt Issue	Debt Rating	Issue Date	Original Issue Amount	Index	Stated Maturity	Estimated Callable Date	Principal Outstanding At Mar. 31, 2002	Interest Rate At Mar. 31, 2002
Sequoia 1 A1	AAA	7/29/97	$ 334,347	1m LIBOR	2/15/28	Called	$ 0	N/A
Sequoia 1 A2	AAA	7/29/97	200,000	Fed Funds	2/15/28	Called	0	N/A
Sequoia 2 A1	AAA	11/6/97	592,560	1y Treasury	3/30/29	2003	211,894	4.17%
Sequoia 2 A2	AAA	11/6/97	156,600	1m LIBOR	3/30/29	2003	55,999	2.24%
Sequoia 3 A1	AAA	6/26/98	225,459	Fixed to 12/02	5/31/28	Retired	0	N/A
Sequoia 3 A2	AAA	6/26/98	95,000	Fixed to 12/02	5/31/28	Retired	0	N/A
Sequoia 3 A3	AAA	6/26/98	164,200	Fixed to 12/02	5/31/28	2002	6,844	6.35%
Sequoia 3 A4	AAA	6/26/98	121,923	Fixed to 12/02	5/31/28	2002	121,923	6.25%
Sequoia 3 M1	AA/AAA	6/26/98	16,127	Fixed to 12/02	5/31/28	2002	16,127	6.79%
Sequoia 3 M2	A/AA	6/26/98	7,741	Fixed to 12/02	5/31/28	2002	7,741	6.79%
Sequoia 3 M3	BBB/A	6/26/98	4,838	Fixed to 12/02	5/31/28	2002	4,838	6.79%
Sequoia 1A A1	AAA	5/4/99	157,266	1m LIBOR	2/15/28	2002	50,123	2.27%
Sequoia 4 A	AAA	3/21/00	377,119	1m LIBOR	8/31/24	2005	239,279	2.26%
Commercial 1	N/A	3/30/01	8,891	1m LIBOR	11/1/02	N/A	9,010	4.84%
Commercial 2	N/A	3/30/01	8,320	1m LIBOR	10/1/03	N/A	8,320	4.84%
Sequoia 5 A	AAA	10/29/01	496,667	1m LIBOR	10/29/26	2006	481,979	2.25%
Sequoia 5 B1	AA	10/29/01	5,918	1m LIBOR	10/29/26	2006	5,918	2.70%
Sequoia 5 B2	A	10/29/01	5,146	1m LIBOR	10/29/26	2006	5,146	2.70%
Sequoia 5 B3	BBB	10/29/01	2,316	1m LIBOR	10/29/26	2006	2,316	2.70%
Commercial 3	N/A	3/1/02	8,318	1m LIBOR	7/1/03	N/A	8,318	8.63%
Total Long-Term Debt			$2,988,756				$1,235,775	3.19%

In 2001, Fitch Ratings, a credit rating agency, upgraded the credit ratings on three of our debt issues (Sequoia 3 M1 to M3). In April 2002 we issued $502 million of long-term debt through Sequoia 6.

Operating Expenses

Our ratio of operating expenses to equity decreased to 4.15% in the first quarter of 2002, from 5.49% in the first quarter of 2001. Our efficiency ratio (operating expenses divided by net interest income after credit expenses) decreased to 23% in the first quarter of 2002 from 30% in the first quarter of 2001. We expect our total operating expenses to be higher in 2002 (from the $12 million in 2001) as a result of improved performance (as a significant portion of our compensation expenses are performance based) and increased staffing due to the increase in capital and assets. Operating expenses increased 19% from the first quarter of 2001 as compared to the first quarter of 2002. However, our average total equity increased by 56% from the first quarter of 2001 as compared to the first quarter of 2002. If we continue to increase the scale of our business, we expect to continue to benefit from operating leverage, as we would expect growth in our operating expenses would be restrained relative to growth in equity and net interest income.

We report Holdings on a consolidated basis. In years prior to 2001, we accounted for our interest in Holdings as an equity investment; our losses from Holdings in these years were reported as “other income and expense.” The costs of business units that were closed are the primary expenses associated with Holdings in 2000.

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Table 25

Operating Expenses
(all dollars in thousands)

	Reported Operating Expenses	Unconsolidated Holdings Expenses	Operating Expenses Of Closed Business Units	Operating Expenses From Ongoing Operations	Operating Expenses/ Average Equity	Efficiency Ratio: Operating Expenses/ Net Interest Income
Q1: 2001	$ 2,980	$ 0	$ 0	$ 2,980	5.49%	30%
Q2: 2001	3,378	0	0	3,378	6.13%	30%
Q3: 2001	2,748	0	0	2,748	4.32%	24%
Q4: 2001	2,730	0	0	2,730	3.60%	21%
Q1: 2002	3,546	0	0	3,546	4.15%	23%
2000	$ 7,850	$ 2,391	$ (221)	$ 10,020	4.68%	33%
2001	11,836	0	0	11,836	4.75%	26%

Other Income (Expense)

In the first quarter of 2002, other income and expense primarily consisted of variable stock option expense associated with certain stock options. This expense, a type of mark-to-market expense, occurred as our stock price rose above the underlying strike price on a small portion of our outstanding stock options.

Mark-to-Market Adjustments

Changes in the market value of certain of our mortgage assets and interest rate agreements affect our GAAP earnings each quarter. For the first quarter of 2002, income statement mark-to-market adjustments totaled a positive $0.9 million. We also mark-to-market certain assets through our balance sheet; these adjustments affect our reported book value but not our earnings. Net balance sheet and income statement mark-to-market adjustments were positive $9.2 million in the first quarter of 2002. This increase in market values was due in part to favorable prepayment and credit performance on some of our residential credit-enhancement securities.

Shareholder Wealth

In the 7.5 years since the commencement of Redwood's operations, cumulative shareholder wealth has grown at a compound rate of 18% per year. We define shareholder wealth as growth in tangible book value per share, plus dividends paid, plus reinvestment of dividends. In calculating shareholder wealth, we assumed that dividends were reinvested through the purchase of additional shares at the prevailing book value per share. With this assumption, the shareholder wealth we have created can be compared to book value per share growth at a non-REIT company that has retained its earnings and compounds book value within the company. This is a measure of management value-added, not a measure of actual shareholder returns.

Book value per share was $11.67 in September 1994 when we commenced operations. We increased book value to $23.11 per share at March 31, 2002 through the retention of cash by keeping dividends lower than cash flow, net positive changes in market values of assets, issuance of stock at prices above book value, and repurchases of stock below book value. Since we mark-to-market many of our assets through our balance sheet, reported book value is a good approximation of tangible value in the company. Cumulative dividends paid during this period were $10.49 per share, and reinvestment earnings on those dividends were $7.11 per share. Thus, cumulatively, shareholder wealth has increased from $11.67 per share to $40.71 per share during this 7.5 year period. A company that earned an 18% after-tax return on equity and retained all its earnings would have shown a similar amount of shareholder wealth growth during this period.

Table 26

Shareholder Wealth
(dollars per share)

	Book Value Per Share	Dividends Declared During Period	Cumulative Dividends	Cumulative Reinvestment Earnings on Dividends	Cumulative Shareholder Wealth
Sep. 1994	$11.67	$ 0.00	$ 0.00	$ 0.00	$ 11.67
Dec. 1994	10.82	0.25	0.25	0.00	11.07
Dec. 1995	12.38	0.96	1.21	0.09	13.68
Dec. 1996	16.50	1.67	2.88	1.07	20.45
Dec. 1997	21.55	2.15	5.03	3.07	29.65
Dec. 1998	20.27	0.28	5.31	2.67	28.25
Dec. 1999	20.88	0.40	5.71	3.07	29.66
Dec. 2000	21.47	1.61	7.32	4.11	32.90
Dec. 2001	22.21	2.55	9.87	6.03	38.11
Mar. 2002	23.11	0.62	10.49	7.11	40.71

Taxable Income and Dividends

We generally intend to distribute over time as preferred and common stock dividends 100% of our REIT taxable income earned at our parent company, Redwood Trust, which has elected REIT status. Our REIT taxable income may differ materially from our core earnings or reported GAAP income.

Our common stock dividend policy and distributions are set by our Board of Directors. Generally, distributions depend on our REIT taxable income, GAAP earnings, cash flows, overall financial condition, maintenance of REIT status, and such other factors as the Board of Directors deems relevant. The Board of Directors may reduce our regular dividend rate when it believes it may be in the long-term interest of Redwood Trust and its shareholders to do so. No dividends will be paid or set apart for payment on shares of our common stock unless full cumulative dividends have been paid on our Class B 9.74% Cumulative Convertible Preferred Stock. As of March 31, 2002, full cumulative dividends have been paid on the Class B Preferred Stock.

Under current policy, the Board sets our regular dividend at a rate that it believes is more likely than not to be sustainable, given current expectations for cash flow generation and other factors. In years when our dividend distribution requirements exceed what we believe to be our sustainable dividend rate, the Board may declare one or more special quarterly cash dividends.

Distributions to our shareholders will generally be subject to tax as ordinary income, although a portion of such distributions may be designated by us as capital gain or may constitute a tax-free return of capital. All dividends declared and paid in the last three years have been ordinary income. Our Board of Directors may elect to maintain a steady dividend rate during periods of fluctuating REIT taxable income. In such event, the Board may choose to declare dividends that include a return of capital. We will generally attempt to avoid acquiring assets or structuring financings or sales at the REIT corporate level that may generate unrelated business taxable income (UBTI) or excess inclusion income for our shareholders; there can be no assurance that we will be successful in doing so. We annually furnish to each shareholder a statement setting forth distributions paid during the preceding year and their characterization as ordinary income, capital gains or return of capital. For a discussion of the Federal income tax treatment of our distributions, see "Federal Income Tax Considerations — Taxation of Holders of Redwood Trust's Common Stock" in our Annual Report on Form 10-K for the year ended December 31, 2001.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of certain assets and liabilities at the date of the financial

statements and the reported amounts of certain revenues and expenses during the reported period. Actual results could differ from those estimates. The critical accounting policies, and how changes in estimates might affect our financial results and statements, are discussed below.

We estimate the fair value of our assets and hedges using available market information and other appropriate valuation methodologies. We believe the estimates we use accurately reflect the values we may be able to receive should we choose to sell them. Our estimates are inherently subjective in nature and involve matters of uncertainty and judgment to interpret relevant market and other data. Many factors are necessary to estimate market values, including, but not limited to interest rates, prepayment rates, and amount and timing of credit losses.

In addition to our valuation processes, we are active acquirers, and occasional sellers, of the assets we own and we are users of hedges. Thus, we have the ability to understand and determine changes in assumptions that are taking place in the market place, and make appropriate changes in our assumptions for valuing assets in our portfolio. In addition, we use third party sources to assist in developing our estimates. Furthermore, for many of the assets we pledge to obtain collateralized short-term borrowings, we obtain market valuations from our counter-parties on our assets in order to establish the maximum amount of borrowings.

Changes in the perceptions regarding future events can have a material impact on the value of such assets. Should such changes, or other factors, result in significant changes in the market values, our income and/or book value could be adversely affected.

We recognize revenue on our assets using the effective yield method. The use of this method requires us to project the cash flow over the remaining life of each asset. Such projections include assumptions about interest rates, prepayment rates, timing and amount of credit losses, when certain tests will be met that may allow for changes in payments made under the structure of securities, and other factors. There can be no assurance that our assumptions used to generate future cash flows, or the current period's yield for each asset, will prove to be accurate. Our current period earnings may not accurately reflect the yield to be earned on that asset for the remaining life.

We review our cash flow projections on an ongoing basis. We monitor the critical performance factors for each loan and security. Our expectations of future asset cash flow performance are shaped by input and analysis received from external sources, internal models, and our own judgment and experience.

One significant assumption used in projecting cash flows on many of our assets, and thus our current yield, is the level and timing of credit losses that we expect to incur over the lives of these assets. We establish the level of future estimated credit losses as a credit reserve. The reserve is based upon our assessment of various factors affecting our assets, including current and projected economic conditions, characteristics of the underlying loans, delinquency status, and external credit protection. Our actual credit losses, and the timing of these losses, may differ from those estimates used to establish the reserve. Such differences will result in different yields over the life of the asset than we may be currently reporting under GAAP. If such differences are adverse, and the market value of our assets decline below our carrying value, we may need to take current period mark-to-market charges through our income statement.

We continually review and update, as appropriate, all of our assumptions. Despite this continual review, there can be no assurance that our assumptions used to estimate cash flows, fair values, and effective yields will prove to be correct as interest rates, economic conditions, real estate conditions, and the market's perception of the future constantly change.

FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES

Cash Flow

Cash flow from operations equals earnings adjusted for non-cash items such as depreciation, amortization, provisions, and mark-to-market adjustments. Free cash flow equals cash flow from operations less capital expenditures and increases in working capital. Generally, free cash flow plus principal receipts from assets are available to pay dividends, pay down debt, repurchase stock, or acquire new portfolio assets. Funds retained to

support a net increase in portfolio investment generally equal free cash flow less dividends plus any net issuance of stock.

Over the past several quarters, our cash flow from operations has exceeded our earnings and our dividend distributions. In the first quarter of 2002, cash flow from operations was $14 million, consisting of earnings of $11 million plus non-cash depreciation, amortization, compensation, and mark-to-market adjustments of $3 million. Our free cash flow, which is our cash flow from operations plus changes in working capital, property, plant, equipment, and other non-earning assets, was $13 million. In addition, we issued $46 million in common stock during the quarter through a common stock offering and our direct stock purchase and dividend reinvestment plan. We used the available cash from these sources to fund our common stock dividend of $8 million and to increase our net investment in our real estate activities by $51 million.

The presentation of free cash flow and funds available for portfolio investing is intended to supplement the presentation of cash provided by operating activities in accordance with GAAP. Since all companies do not calculate these alternative measures of cash flow in the same fashion, free cash flow and funds retained for portfolio investing may not be comparable to similarly titled measures reported by other companies.

Table 27

Cash Flow
(all dollars in thousands)

	GAAP Earnings	Non-Cash Items	Cash Flow From Operations	Changes In Working Capital And Other Assets	Free Cash Flow	Common Dividends Paid	(Purchase)/ Sale Of Stock	Net Funds Available for Portfolio Investing
Q1: 2001	$ 6,680	$ 1,345	$ 8,025	$ 4,515	$12,540	$ (3,876)	$ 986	$ 9,650
Q2: 2001	6,463	3,004	9,467	(1,096)	8,371	(4,448)	548	4,471
Q3: 2001	8,065	2,386	10,451	366	10,817	(6,715)	50,586	54,688
Q4: 2001	8,955	6,496	15,451	562	16,013	(8,268)	33,665	41,410
Q1: 2002	11,219	2,780	13,999	(1,125)	12,874	(7,597)	46,162	51,439
2000	$16,210	$ 8,873	$ 25,083	$ 2,368	$27,451	$(12,488)	$ 428	$ 15,391
2001	30,163	13,231	43,394	4,347	47,741	(23,307)	85,785	110,219

Our ability to retain significant amounts of the free cash flow that we generate may be diminished in the future should our minimum dividend distribution requirements increase relative to our free cash flow (see the discussion on “Taxable Income and Dividends” above).

Short-Term Borrowings and Liquidity

A substantial majority of our short-term borrowings have maturities of one year or earlier and generally have interest rates that change monthly to a margin over or under the one month LIBOR interest rate.

Some of our short-term borrowing facilities are committed (for which we pay fees) but most are uncommitted. Our facilities are generally for a term of up to one year, although certain assets maybe funded for periods up to three years. These facilities have restrictions on pledged asset types and debt covenant tests; we continue to meet these requirements.

At March 31, 2002, we had over a dozen uncommitted facilities for short-term collateralized debt, with credit approval for $4 billion of borrowings. We have had no difficulty securing short-term borrowings on favorable terms. Outstanding borrowings under these agreements were $526 million at March 31, 2002, a decrease from $568 million at year-end 2001 due to a reduction in our securities portfolio.

We also had two short-term facilities available to fund our residential mortgage loan portfolio at March 31, 2002. These facilities totaled over $1 billion; we had $551 million outstanding borrowings at March 31, 2002, and $146 million outstanding borrowings at December 31, 2001. We anticipate using these and other new facilities as we continue to acquire whole loans in anticipation of a securitization.

We had four borrowing facilities for residential credit-enhancement securities totaling $170 million and two borrowing facilities for commercial mortgage loans totaling $57 million outstanding at March 31, 2002. Outstanding borrowings under these agreements were $40 million at March 31, 2002, a decrease from the $83 million at December 31, 2001.

At this time, we see no material negative trends that we believe would affect our access to short-term borrowings or bank credit lines sufficient to maintain safe operations, that would suggest that our liquidity reserves would be called upon, or that would likely cause us to be in danger of a covenant default. However, many factors, including ones external to us, may affect our liquidity in the future.

In the first quarter of 2002, we added borrowing facilities for our residential credit-enhancement securities and our residential mortgage loans. We intend to add other borrowing facilities throughout the year. There can be no assurance that we will be able to find or retain sufficient borrowing agreements to fund our current operations or our potential acquisition opportunities.

Under our internal risk-adjusted capital system, we maintain liquidity reserves in the form of cash and unpledged liquid assets. These liquidity reserves may be needed for a variety of reasons, including a decline in the market value, or a change in the acceptability to lenders, of the collateral we pledge to secure short-term borrowings. We continue to maintain liquidity reserves at or in excess of our policy levels. At March 31, 2002, we had $64 million of unrestricted cash and highly liquid (unpledged) assets available to meet potential liquidity needs. Total available liquidity equaled 6% of our short-term debt balances. At December 31, 2001, we had $74 million of liquid assets, equaling 9% of our short-term debt balances.

Long-Term Debt

The $1.2 billion of long-term debt on our March 31, 2002 consolidated balance sheet was non-recourse debt. Substantially all this debt was issued through our special purpose financing subsidiary, Sequoia, and was collateralized by residential mortgage loans. The holders of our long-term debt can look only to the cash flow from the mortgages specifically collateralizing the debt for repayment. By using this source of financing, our liquidity risks are limited. Our special purpose financing subsidiaries that issue debt have no call on Redwood's general liquidity reserves, and there is no debt rollover risk as the loans are financed to maturity. The market for AAA-rated long-term debt of the type that we issue to fund residential loans through Sequoia is a large, global market that has been relatively stable for many years. At this time, we believe we could issue more of this debt on reasonable terms if we should choose to do so. In April 2002, we issued $502 million of long-term debt through Sequoia 6.

The remaining $26 million of our long-term debt was backed by commercial loans and was created through the sale of senior loan participations. In March 2002, we sold a senior participation on a commercial loan for $8 million. The market for senior participations on commercial loans of the types in our portfolio is limited and there can be no assurance that we will be able to sell future participations.

Equity Capital and Risk-Adjusted Capital Guidelines

Excluding short- and long-term collateralized debt, we are capitalized entirely by common and preferred equity capital. Our equity base increased from $308 million to $364 million in the first quarter of 2002 as a result of an equity offering totaling $40 million, $8 million in asset appreciation, $3 million in retention of cash flow, and $6 million in stock issuance through our direct stock purchase and dividend reinvestment program. We raised another $21 million of new capital through an equity offering and our direct stock purchase and dividend reinvestment program in April 2002. We will seek to raise additional equity capital in the future when opportunities to expand our business are attractive and when we believe such issuance is likely to benefit long-term earnings and dividends per share.

The amount of assets that can be supported with a given capital base is limited by our internal risk-adjusted capital policies. Our risk-adjusted capital policy guideline amounts are expressed in terms of an equity-to-assets ratio and vary with market conditions and asset characteristics. Our risk-adjusted capital guideline is further discussed under "Capital Risks". At March 31, 2002, our aggregate equity capital guidelines

were: 75% of residential credit-enhancement portfolio interests; 100% of net retained interests in residential loan portfolio after long-term debt issuance (Sequoia equity); 11% of short-term debt funded residential mortgage loans; 16% of securities portfolio; and 30% of commercial mortgage loan portfolio.

Our total risk-adjusted capital guideline amount for assets on our balance sheet was $342 million (12% of asset balances) at March 31, 2002. Capital required for outstanding commitments at March 31, 2002 for asset purchases settling in the second quarter of 2002 was $14 million. Thus, at March 31, 2002, our total capital committed at quarter end was $356 million, our total capital available was $364 million, and our excess capital to support growth in the second quarter of 2002 was $8 million.

Balance Sheet Leverage

As reported on our balance sheet of March 31, 2002, our equity-to-reported-assets ratio was 13% and our reported debt-to-equity ratio was 6.5 times. We believe our balance sheet is generally less leveraged than many banks, savings and loans, and other financial institutions such as Fannie Mae and Freddie Mac that are in similar real estate finance businesses.

A majority of our debt is non-recourse debt. Holders of non-recourse debt can look only to the pledged assets — and not to Redwood Trust — for repayment. Therefore, another useful measure of the leverage we employ is to compute leverage ratios comparing our equity base to our recourse debt levels and to our "at-risk" assets (our assets excluding those assets pledged to non-recourse debt). These adjustments generally conform our balance sheet to what would be reported if we accounted for our securitizations as sales rather than as financings. Total reported assets at March 31, 2002 were $2.7 billion; of these, $1.2 billion were pledged to non-recourse debt and $1.5 billion were "at-risk". Total reported liabilities at March 31, 2002 were $2.4 billion; non-recourse debt was $1.2 billion and recourse debt was $1.1 billion. Our ratio of equity-to-at-risk-assets was 24% and our ratio of recourse-debt-to-equity was 3.1 times. Please also see "Net Interest Income" above for a discussion of our income statement as reformatted to a recourse basis.

Our long-term plan is to reduce short-term recourse debt levels, in part by replacing this debt with long-term non-recourse debt. If we are successful in this funding strategy, and we continue to grow, our reported leverage levels may increase at the same time that our recourse leverage levels may decrease.

Table 28

Leverage Ratios
(all dollars in thousands)

	At Risk Assets	Recourse Debt And Other Liabilities	Equity	Equity To At-Risk Assets	Recourse Debt and Liabilities To Equity	Equity To Reported Assets	Reported Debt To Equity
Q1: 2001	$1,226,951	$1,005,280	$221,671	18%	4.5	10%	9.3
Q2: 2001	1,099,885	875,871	224,014	20%	3.9	11%	8.3
Q3: 2001	1,387,409	1,107,557	279,852	20%	4.0	12%	7.1
Q4: 2001	1,120,061	812,288	307,773	28%	2.6	13%	6.9
Q1: 2002	1,503,744	1,139,300	364,444	24%	3.1	13%	6.5
2000	$ 983,097	$ 767,433	$215,664	22%	3.6	10%	8.7
2001	1,120,061	812,288	307,773	28%	2.6	13%	6.9

RISK MANAGEMENT

We seek to manage the risks inherent in all financial institutions — including credit risk, liquidity risk, interest rate risk, prepayment risk, market value risks, and capital risks — in a prudent manner designed to insure Redwood's longevity. At the same time we endeavor to provide our shareholders an opportunity to realize a steady, and rising dividend and an attractive total rate of return through stock ownership in our company. In general, we seek, to the best of our ability, to assume risks that can be quantified from historical experience, to

actively manage such risks, to earn sufficient compensation to justify the taking of such risks, and to maintain capital levels consistent with the risks we do take.

Credit Risk

The majority of our credit risk comes from high-quality residential mortgage loans. This includes residential mortgage loans we own and loans we effectively “guarantee” or “insure” through acquisitions of credit-enhancement securities. We also are exposed to credit risks in our commercial mortgage loan portfolio. A small amount of our securities portfolio is currently exposed to credit risk; the bulk of this portfolio has very high credit ratings and would not normally be expected to incur credit losses. We also have credit risk with counter-parties with whom we do business.

It should be noted that the establishment of a credit reserve for GAAP or a designated credit reserve under the effective yield method does not reduce our taxable income or our dividend payment obligations as a REIT. For taxable income, many of our credit expenses will be recognized only as incurred. Thus, the timing and recognition amount of credit losses for GAAP and tax, and for our earnings and our dividends, may differ. A material increase in actual credit losses may not affect our GAAP income due to our credit reserves but could materially reduce our dividend payment obligations.

The method that we use to account for future credit losses depends upon the type of asset that we own. For our credit-enhancement securities, we establish a credit reserve upon the acquisition of such assets under the effective yield method of accounting. In addition, first loss and other credit-enhancement interests that are junior to our positions that we do not own act as a form of external credit reserve for us on a specific asset basis; these interests junior to ours will absorb credit losses in the pool of underlying mortgage loans before the principal of our interest in that pool of loans will be affected. For our residential and commercial mortgage loans, we establish a credit reserve based on anticipation of losses by taking credit provisions through our income statement. Most of the assets in our securities portfolio do not have material credit risk, and, thus, no credit reserves have been established to date for these assets. When we acquire assets for this portfolio where credit risk exists, we will establish the appropriate reserve as necessary in our estimation.

Liquidity Risk

Our primary form of financing is the issuance of long-term non-recourse securitized debt that very closely matches the interest rate, prepayment rate, and maturities of our assets that we pledge to secure this debt. Once we issue this debt, our recourse exposure to the underlying assets is limited to our net investment after debt issuance. We believe this is a secure and robust form of financing that effectively eliminates liquidity risk for this portion of our balance sheet and eliminates a variety of other potential risks as well. As a part of our long-term planning, we generally intend to reduce our short-term debt levels. We expect, under our current plan, that our primary use of short-term debt will be to fund assets under accumulation for securitization.

Our primary liquidity risk arises from financing long-maturity mortgage assets with short-term debt. Even if the interest rate adjustments of these assets and liabilities are well matched, maturities may not be matched. Trends in the liquidity of the capital markets in general may affect our ability to rollover short-term debt. At March 31, 2002, we had $1.1 billion of short-term debt collateralized by assets. Of this debt, $526 million was collateralized by investment-grade securities, $46 million by residential credit-enhancement securities, and $551 million by high-quality residential mortgage loans under accumulation for a future securitization. If our short-term debt was called, or we could not renew lines, we may need to sell assets in a potentially unfavorable environment. There can be no assurance that such sales would satisfy our liabilities. The events of September 11, 2001 did not impact our liquidity. We have and continue to develop business continuity plans which may help preserve access to liquidity and help mitigate the effect of any disruptions to our operations in the event of certain disasters.

The table below presents our contractual obligations as of March 31, 2002. The debt appears on our balance sheet. The operating leases are commitments which are expensed as paid per terms of the contracts. Additional information on these obligations is presented in our Notes to Consolidated Financial Statements.

Table 29

Contractual Obligations as of March 31, 2002
(all dollars in thousands)

	Total	Stated Maturities	Comments
Short-term debt	$1,122,513	2002	Weighted average maturity is 78 days
Long-term debt, residential	$1,208,889	2017 - 2029	Non-recourse debt amortizes as residential collateral pays down
Long-term debt, commercial	$ 25,570	2002 - 2003	Non-recourse debt amortizes as commercial collateral pays down
Asset purchase commitments	$ 163,860	2002	Most acquisitions were completed in April 2002
Operating leases	$ 2,452	2002 - 2005	Office rent and software licenses

Interest Rate Risk

Our strategy is to maintain an asset/liability posture that is effectively match-funded so that the achievement of our long-term goals is unlikely to be affected by changes in interest rates, yield curves, or mortgage prepayment rates. At March 31, 2002, the interest rate characteristics of our debt closely matched the interest rate characteristics of our assets that were funded with debt. We had $2.3 billion of adjustable-rate debt matched with $2.3 billion of adjustable-rate assets. We had $364 million of equity invested primarily in fixed rate assets and working capital.

As a part of our current asset/liability strategy, we have been maintaining a slight mismatch between the interest rate adjustment periods of our adjustable-rate debt and our adjustable-rate assets. In effect, we own six-month LIBOR assets (and, to a lesser degree, one-year Treasury index assets) funded with one-month LIBOR debt. The interest rate on this debt adjusts each month to the current one-month LIBOR interest rate plus a margin. The interest rate on the six-month LIBOR assets adjusts more slowly to market conditions; each month the coupon rate on approximately one-sixth of these assets adjusts to the current six-month LIBOR interest rate plus a margin. Any single change in short-term interest rates could thus have some short-term effect on our earnings (generally, for the next two quarters). We would expect that the spread between our asset yields and our cost of borrowed funds would be more favorable in a falling short-term interest rate environment than in a rising short-term interest rate environment. This trend may be partially or fully offset over time by the equity-funded portion of our balance sheet, which would generally have increasing net interest earnings (and perhaps better credit results) in a rising rate environment. Short-term interest rates fell throughout 2001, and our earnings benefited from this pricing adjustment mismatch. We would expect our spread to narrow over the next few quarters assuming interest rates stabilize or rise.

We have achieved our desired asset/liability mix on-balance sheet. As the table below shows our variable-rate assets are generally funded with variable-rate debt and our fixed-rate assets are generally funded with equity. As a result, we have generally ceased our hedging activities. We intend to use interest rate agreements as part of our asset/liability strategy in the future to achieve our asset/liability management goals.

Table 30

Asset / Liability Matching as of March 31, 2002
(all dollars in thousands)

Asset Type	Asset Amount	One Month LIBOR Liabilities	One Year Treasury Liabilities	Hybrid Liabilities	Non-Interest Bearing Liabilities	Equity	Total Liabilities And Equity
Cash (unrestricted)	$ 9,960	$ 9,960	$ 0	$ 0	$ 0	$ 0	$ 9,960
One Month LIBOR	955,767	955,767	0	0	0	0	955,767
Six Month LIBOR	847,829	847,829	0	0	0	0	847,829
COFI/Other ARM	84,526	84,526	0	0	0	0	84,526
One Year Treasury	443,825	231,931	211,894	0	0	0	443,825
Fixed / Hybrid<1 Yr*	41,000	15,065	0	0	0	25,935	41,000
Hybrid	195,633	0	0	0	0	195,633	195,633
Fixed	134,324	0	0	0	0	134,324	134,324
Non-Earning Assets	26,974	0	0	0	18,422	8,552	26,974
Total	$2,739,838	$2,145,078	$211,894	$ 0	$ 18,422	$364,444	$2,739,838

* :Projected principal receipts on fixed-rate and hybrid assets over the next twelve months.

Changes in interest rates can have many effects on our business aside from those discussed in this section, including effects on our liquidity, market values, and mortgage prepayment rates.

Prepayment Risk

We seek to maintain an asset/liability posture that mitigates the effects that mortgage prepayment trends may have on our ability to achieve our long-term objectives. For the development of our business, there are positive and negative aspects to both slow prepayment rate environments and fast prepayment rate environments. In general, it would be difficult to say which scenario would be preferred over the longer term.

Prepayments affect short-term earnings primarily through amortization of purchase premium and discount. Although we have roughly equal amounts of premium and discount, variations in a specific asset's current and long-term estimated prepayment rates and differing accounting methods for various types of assets can cause earnings fluctuations as individual asset prepayment rates change.

Table 31

Unamortized Premium and Discount Balances
(all dollars in thousands)

	Gross Premium	Gross Discount	Net Premium/ (Discount)	Net Amortization (Expense)
Q1: 2001	$29,598	$(25,809)	$ 3,789	$ (869)
Q2: 2001	29,046	(36,230)	(7,184)	(1,885)
Q3: 2001	27,921	(34,308)	(6,387)	(1,977)
Q4: 2001	26,518	(30,562)	(4,044)	(4,852)
Q1: 2002	23,036	(32,053)	(9,017)	(3,201)
2000	$25,437	$(21,400)	$ 4,037	$ (2,335)
2001	26,518	(30,562)	(4,044)	(9,583)

We could have material net premium amortization expenses even if we do not have a high net premium balance. This could occur because our premium mortgage assets generally prepay at a faster rate than do our discount mortgage assets, and because the yields of our premium assets are generally more sensitive to

changes in prepayment rates than are the yields of our discount assets. Yields for most of our assets are affected both by estimated future long-term prepayment rates and by current prepayment rates.

Market Value Risk

At March 31, 2002, we owned mortgage securities and loans totaling $1.1 billion that we account for on a mark-to-market basis (in the case of mortgage loans, on a lower-of-cost-or-market basis) for purposes of determining reported earnings. Of these assets, 100% had adjustable-rate coupons. At March 31, 2002, we owned $393 million of assets that were marked-to-market through our balance sheet but not our income statement. Market value fluctuations of these assets can affect the reported value of our stockholders' equity base. Market value fluctuations for our assets not only affect our reported earnings and book value, but also can affect our liquidity, especially to the extent these assets are funded with short-term borrowings.

We currently do not have a significant number of interest rate agreements. Our interest rate agreements are reported at market value with any periodic changes reported either through the income statement or our balance sheet. To the extent we seek hedge accounting under SFAS 133, certain assets whose market value changes would not generally be reported through our income statement may have such market value changes reported through the income statement in the future.

Capital Risk

Our capital levels, and thus our access to borrowings and liquidity, may be tested, particularly if the market value of our assets securing our short-term borrowings declines or the market for short-term borrowings changes in an adverse manner.

Through our risk-adjusted capital policy, we assign a guideline capital adequacy amount, expressed as a guideline equity-to-assets ratio, to each of our mortgage assets. For short-term funded assets, this ratio may fluctuate over time, based on changes in that asset's credit quality, liquidity characteristics, potential for market value fluctuation, interest rate risk, prepayment risk, and the over-collateralization requirements for that asset set by our collateralized short-term lenders. Capital requirements for securities rated below AA, residential credit-enhancement interests, retained interests from our Sequoia securitizations of our residential retained portfolio assets, commercial mortgage whole loans, and retained commercial mortgage junior participants are generally higher than for higher-rated securities and residential whole loans. Capital requirements for less-liquid assets depend chiefly on our access to secure funding for these assets, the number of sources of such funding, the funding terms, and the amount of extra capital we decide to hold on hand to protect against possible liquidity events with these assets. Capital requirements for our retained interests in Sequoia generally equal our net investment. The sum of the capital adequacy amounts for all of our mortgage assets is our aggregate capital adequacy guideline amount.

We do not expect that our actual capital levels will always exceed the guideline amount. If interest rates were to rise in a significant manner, our capital guideline amount may rise, as the potential interest rate risk of our assets would increase, at least on a temporary basis, due to periodic and life caps and slowing prepayment rates for mortgage assets. We measure all of our assets funded with short-term debt at estimated market value for the purpose of making risk-adjusted capital calculations. Our actual capital levels, as determined for our risk-adjusted capital policy, would likely fall as rates increase and as the market values of our assets, net of mark-to-market gains on hedges, decrease. Such market value declines may be temporary, as future coupon adjustments on adjustable-rate mortgage loans may help to restore some of the lost market value.

In this circumstance, or any other circumstance in which our actual capital levels decreased below our capital adequacy guideline amount, we would generally cease the acquisition of new assets until capital balance was restored through prepayments, interest rate changes, or other means. In certain cases prior to a planned equity offering or other circumstances, the Board of Directors may authorize management to acquire assets in a limited amount beyond the usual constraints of our risk-adjusted capital policy.

Inflation Risk

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates, changes in interest rates, and other factors drive our performance far more than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates.

Our financial statements are prepared in accordance with GAAP and, as a REIT, our dividends must equal at least 90% of our net REIT income as calculated for tax purposes. In each case, our activities and balance sheet are measured with reference to historical cost or fair market value without considering inflation.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For a discussion on the quantitative disclosures about market risk, please refer to our Risk Management presentation in Management's Discussion and Analysis of Financial Condition and Results of Operations above. We believe our quantitative risk has not materially changed from our disclosures under Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K for the year ended December 31, 2001.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

At March 31, 2002, there were no pending material legal proceedings to which the Company was a party or of which any of its property was subject.

Item 2. Changes in Securities

Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit 10.14.5 Amended and Restated Executive and Non-Employee Director Stock Option Plan, amended January 24, 2002

Exhibit 11.1 to Part I — Computation of Earnings Per Share for the three and nine months ended March 31, 2002 and March 31, 2001.

(b) Reports

None

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.

Dated: May 10, 2002

By: /s/ DOUGLAS B. HANSEN

Douglas B. Hansen
President
(authorized officer of registrant)

Dated: May 10, 2002

By: /s/ HAROLD F. ZAGUNIS

Harold F. Zagunis
Vice President, Chief Financial Officer
Secretary, Treasurer and Controller
(principal financial and accounting officer)

EXHIBIT 10.14.5

REDWOOD TRUST, INC.

AMENDED AND RESTATED

1994 EXECUTIVE AND NON-EMPLOYEE DIRECTOR

STOCK OPTION PLAN

(Last Amended January 24, 2002)

Section 1. General Purpose of Plan; Definitions.

The name of this plan is the Redwood Trust, Inc. Amended and Restated 1994 Executive and Non-Employee Director Stock Option Plan (the "Plan"). The Plan was adopted by the Board on June 23, 1994, subject to the approval of the Company stockholders, which approval was obtained on June 23, 1994. The Board approved amendments to the Plan on March 8, 1996 which became effective upon approval by the Company's stockholders on June 14, 1996. The Board approved additional non-material amendments on December 13, 1996, June 12, 1997 and June 4, 1998, all of which became effective on such respective dates. The purpose of the Plan is to enable the Company and its Subsidiaries to obtain and retain competent personnel who will contribute to the Company's success by their ability, ingenuity and industry, to give the Company's non-employee directors a proprietary interest in the Company and to provide incentives to the participating directors, officers and other key employees, and agents and consultants that are linked directly to increases in stockholder value and will therefore inure to the benefit of all stockholders of the Company.

For purposes of the Plan, the following terms shall be defined as set forth below:

(1) "Accrued DERs" means DERs with the accrual rights described in Section 5(11).

(2) "Administrator" means the Board, or if the Board does not administer the Plan, the Committee in accordance with Section 2.

(3) "Board" means the Board of Directors of the Company.

(4) "Code" means the Internal Revenue Code of 1986, as amended from time to time, or any successor thereto.

(5) "Committee" means the Compensation Committee of the Board, which shall be composed entirely of individuals who meet the qualifications to be a "Non-Employee Director" as defined in Rule 16b-3 ("Rule 16b-3) as promulgated by the Securities and Exchange Commission (the "Commission") under the Securities Exchange Act of 1934 (the "Act"), and as such Rule may be amended from time to time, or any successor definition adopted by the Commission, or any other Committee the Board may subsequently appoint to administer the Plan. If at any time the Board shall not administer the Plan, then the functions of the Board specified in the Plan shall be exercised by the Committee.

(6) “Company” means Redwood Trust, Inc., a corporation organized under the laws of the State of Maryland (or any successor corporation).

(7) “Current-pay DERs” means DERs with the current-pay rights described in Section 5(11).

(8) “DERs” shall mean Accrued DERs and Current-pay DERs.

(9) “Deferred Stock” means an award granted pursuant to Section 7 of the right to receive Stock at the end of a specified deferral period.

(10) “Disability” means permanent and total disability as determined under the Company’s disability program or policy.

(11) “Effective Date” shall mean the date provided pursuant to Section 12.

(12) “Eligible Employee” means an employee of the Company or any Subsidiary eligible to participate in the Plan pursuant to Section 4.

(13) “Eligible Non-Employee Director” means a member of the Board or the board of directors of any Subsidiary who is not a bona fide employee of the Company or any Subsidiary and who is eligible to participate in the Plan pursuant to Section 5A.

(14) “Fair Market Value” means, as of any given date, with respect to any awards granted hereunder, at the discretion of the Administrator and subject to such limitations as the Administrator may impose, (A) the closing sale price of the Stock on the next preceding business day as reported in the Western Edition of the Wall Street Journal Composite Tape, or (B) the average of the closing price of the Stock on each day on which the Stock was traded over a period of up to twenty trading days immediately prior to such date, or (C) if the Stock is not publicly traded, the fair market value of the Stock as otherwise determined by the Administrator in the good faith exercise of its discretion.

(15) “Incentive Stock Option” means any Stock Option intended to be designated as an “incentive stock option” within the meaning of Section 422 of the Code.

(16) “Limited Stock Appreciation Right” means a Stock Appreciation Right that can be exercised only in the event of a “Change of Control” (as defined in Section 10 below).

(17) “Non-Employee Director” shall have the meaning set forth in Rule 16b-3.

(18) “Non-Qualified Stock Option” means any Stock Option that is not an Incentive Stock Option, including any Stock Option that provides (as of the time such option is granted) that it will not be treated as an Incentive Stock Option.

(19) “Parent Corporation” means any corporation (other than the Company) in an unbroken chain of corporations ending with the Company, if each of the corporations in the chain (other than the Company) owns stock possessing 50% or more of the combined voting power of all classes of stock in one of the other corporations in the chain.

(20) “Participant” means any Eligible Employee or any consultant or agent of the Company or any Subsidiary selected by the Committee, pursuant to the Administrator’s authority in Section 2, to receive grants of Stock Options, DERs, Stock Appreciation Rights, Limited Stock Appreciation Rights, Restricted Stock awards, Deferred Stock awards, Performance Shares or any combination of the foregoing, or any Eligible Non-Employee Director eligible to receive grants of Non-Qualified Stock Options and DERs pursuant to Section 5A below.

(21) “Performance Share” means an award of shares of Stock granted pursuant to Section 7 that is subject to restrictions based upon the attainment of specified performance objectives.

(22) “Restricted Stock” means an award granted pursuant to Section 7 of shares of Stock subject to restrictions that will lapse with the passage of time.

(23) “Stock” means the common stock, $0.01 par value, of the Company.

(24) “Stock Appreciation Right” means the right pursuant to an award granted under Section 6 to receive an amount equal to the difference between (A) the Fair Market Value, as of the date such Stock Appreciation Right or portion thereof is surrendered, of the shares of Stock covered by such right or such portion thereof, and (B) the aggregate exercise price of such right or such portion thereof.

(25) “Stock Option” means an option to purchase shares of Stock granted pursuant to Section 5 or Section 5A.

(26) “Subsidiary” means (A) any corporation (other than the Company) in an unbroken chain of corporations beginning with the Company, if each of the corporations (other than the last corporation) in the unbroken chain owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in the chain or (B) except for purposes of determining eligibility for receipt of Incentive Stock Options, any corporation or other type of entity (a “company”) (other than the Company) in an unbroken chain of companies beginning with the Company, if each of the companies (other than the last company) in the unbroken chain owns stock or other forms of equity investment (i) possessing 50% or more of the total combined voting power of all classes of stock or other forms of equity in one of the other companies in the chain or (ii) representing 50% or more of the total value of all classes of stock or other forms of equity in one of the other companies in the chain.

Section 2. Administration.

The Plan shall be administered by the Board or by a Committee appointed by the Board, which shall serve at the pleasure of the Board; provided, however, that at all times when the Company is subject to the reporting requirements of the Securities Exchange Act of 1934, as amended, the Plan shall be administered by the Committee appointed by the Board.

The Administrator shall have the power and authority to grant to Eligible Employees and consultants or agents of the Company or any Subsidiary, pursuant to the terms of the Plan: (a) Stock Options (with or without DERs), (b) Stock Appreciation Rights or Limited Stock Appreciation Rights, (c) Restricted Stock, (d) Deferred Stock, (e) Performance Shares or (f) any combination of the foregoing.

In particular, the Administrator shall have the authority:

(a) to select those employees of the Company or any Subsidiary who shall be Eligible Employees;

(b) to determine whether and to what extent Stock Options (with or without DERs), Stock Appreciation Rights, Limited Stock Appreciation Rights, Restricted Stock, Deferred Stock, Performance Shares or a combination of the foregoing, are to be granted to Eligible Employees or any consultant or agent of the Company or any Subsidiary hereunder;

(c) to determine the number of shares to be covered by each such award granted hereunder;

(d) to determine the terms and conditions, not inconsistent with the terms of the Plan, of any award granted hereunder (including, but not limited to, (x) the restricted period applicable to Restricted or Deferred Stock awards and the date or dates on which restrictions applicable to such Restricted or Deferred Stock shall lapse during such period, and (y) the performance goals and periods applicable to the award of Performance Shares); and

(e) to determine the terms and conditions, not inconsistent with the terms of the Plan, which shall govern all written instruments evidencing the Stock Options, DERs, Stock Appreciation Rights, Limited Stock Appreciation Rights, Restricted Stock, Deferred Stock, Performance Shares or any combination of the foregoing.

The Administrator shall have the authority, in its discretion, to adopt, alter and repeal such administrative rules, guidelines and practices governing the Plan as it shall from time to time deem advisable; to interpret the terms and provisions of the Plan and any award issued under the Plan (and any agreements relating thereto); and to otherwise supervise the administration of the Plan.

All decisions made by the Administrator pursuant to the provisions of the Plan shall be final and binding on all persons, including the Company, any Subsidiaries and the Participants.

Notwithstanding anything to the contrary herein, no award hereunder may be made to any Participant to the extent that, following such award, the shares subject or potentially subject to such Participant's control (including, but not limited to, (i) shares of the Company's equity stock owned by the Participant, (ii) Stock Options, whether or not then exercisable, held by the Participant to purchase additional such shares, (iii) Restricted Stock, Deferred Stock and Performance Share awards to the Participant, whether or not then vested, and (iv) Accrued DERs credited to the Participant) would constitute more than 9.8% of the outstanding capital stock of the Company.

Section 3. Stock Subject to Plan.

The total number of shares of Stock reserved and available for issuance under the Plan shall be 500,000; provided, however, that from and after such time as the number of outstanding shares of Stock as reflected on the Company's quarterly or year-end balance sheet exceeds 6,000,000 (including treasury shares but not including adjustments in the event of changes in the corporate structure of the Company as provided below in this Section 3), the total number of shares of Stock reserved and available for issuance under the Plan shall automatically be increased so as to equal

fifteen (15) percent of the number of then outstanding shares of Stock, and provided further, that no more than 500,000 shares of Stock shall be cumulatively available for Incentive Stock Options. At all times, the number of shares reserved and available for issuance hereunder as so determined from time to time shall be decreased by virtue of awards granted and outstanding or exercised hereunder.

To the extent that (i) a Stock Option or DER expires or is otherwise terminated without being exercised, or (ii) any shares of Stock subject to any Restricted Stock, Deferred Stock or Performance Share award granted hereunder are forfeited, such shares shall again be available for issuance in connection with future awards under the Plan. If any shares of Stock have been pledged as collateral for indebtedness incurred by a Participant in connection with the exercise of a Stock Option and such shares are returned to the Company in satisfaction of such indebtedness, such shares shall again be available for issuance in connection with future awards under the Plan.

In the event of any merger, reorganization, consolidation, recapitalization, Stock dividend, or other change in corporate structure affecting the Stock, a substitution or adjustment may be made in (i) the aggregate number of shares reserved for issuance under the Plan, and (ii) the kind, number and option price of shares subject to outstanding Stock Options and DERs granted under the Plan as may be determined by the Administrator, in its sole discretion, provided that the number of shares subject to any award shall always be a whole number. Such other substitutions or adjustments shall be made as may be determined by the Administrator, in its sole discretion; provided, however, that with respect to Incentive Stock Options, such adjustment shall be made in accordance with Section 424 of the Code. An adjusted option price shall also be used to determine the amount payable by the Company upon the exercise of any Stock Appreciation Right or Limited Stock Appreciation Right associated with any Stock Option.

The aggregate number of shares of Stock for which Stock Options or Stock Appreciation Rights may be granted to any individual during any calendar year may not, subject to adjustment as provided in this Section 3, exceed 75% of the shares of Stock reserved for the purposes of the Plan in accordance with the provisions of this Section 3.

Section 4. Eligibility.

Officers and other key employees of the Company or Subsidiaries who are responsible for or contribute to the management, growth and/or profitability of the business of the Company or its Subsidiaries and consultants and agents of the Company or its Subsidiaries, shall be eligible to be granted Stock Options, DERs, Stock Appreciation Rights, Limited Stock Appreciation Rights, Restricted Stock awards, Deferred Stock awards or Performance Shares hereunder. The Participants under the Plan shall be selected from time to time by the Administrator, in its sole discretion, from among the Eligible Employees and consultants and agents recommended by the senior management of the Company, and the Administrator shall determine, in its sole discretion, the number of shares covered by each award; provided, however, that Eligible Non-Employee Directors shall only be eligible to receive Stock Options as provided in Section 5A.

Section 5. Stock Options.

Stock Options may be granted alone or in addition to other awards granted under the Plan, including DERs as described in Section 5(11). Any Stock Option granted under the Plan shall be in such form as the Administrator may from time to time approve, and the provisions of Stock Option

awards need not be the same with respect to each optionee. Recipients of Stock Options shall enter into a stock option agreement with the Company, in such form as the Administrator shall determine, which agreement shall set forth, among other things, the exercise price of the option, the term of the option and provisions regarding exercisability of the option granted thereunder.

The Stock Options granted under the Plan may be of two types: (i) Incentive Stock Options and (ii) Non-Qualified Stock Options.

The Administrator shall have the authority under this Section 5 to grant any optionee (except Eligible Non-Employee Directors) Incentive Stock Options, Non-Qualified Stock Options, or both types of Stock Options (in each case with or without DERs, Stock Appreciation Rights or Limited Stock Appreciation Rights), provided, however, that Incentive Stock Options may not be granted to any individual who is not an employee of the Company or its Subsidiaries. To the extent that any Stock Option does not qualify as an Incentive Stock Option, it shall constitute a separate Non-Qualified Stock Option. More than one option may be granted to the same optionee and be outstanding concurrently hereunder.

Stock Options granted under the Plan shall be subject to the following terms and conditions and shall contain such additional terms and conditions, not inconsistent with the terms of the Plan, as the Administrator shall deem desirable:

(1) Option Price. The option price per share of Stock purchasable under a Stock Option shall be determined by the Administrator in its sole discretion at the time of grant but shall not, in the case of Incentive Stock Options, be less than 100% of the Fair Market Value of the Stock on such date, and shall not, in any event, be less than the par value of the Stock. The option price per share of Stock purchasable under a Non-Qualified Stock Option may be less than 100% of such Fair Market Value. If an employee owns or is deemed to own (by reason of the attribution rules applicable under Section 425(d) of the Code) more than 10% of the combined voting power of all classes of stock of the Company or any Parent Corporation or Subsidiary and an Incentive Stock Option is granted to such employee, the option price of such Incentive Stock Option (to the extent required by the Code at the time of grant) shall be no less than 110% of the Fair Market Value of the Stock on the date such Incentive Stock Option is granted.

(2) Option Term. The term of each Stock Option shall be fixed by the Administrator, but no Stock Option shall be exercisable more than ten years after the date such Stock Option is granted; provided, however, that if an employee owns or is deemed to own (by reason of the attribution rules of Section 425(d) of the Code) more than 10% of the combined voting power of all classes of stock of the Company or any Parent Corporation or Subsidiary and an Incentive Stock Option is granted to such employee, the term of such Incentive Stock Option (to the extent required by the Code at the time of grant) shall be no more than five years from the date of grant.

(3) Exercisability. Stock Options shall be exercisable at such time or times and subject to such terms and conditions as shall be determined by the Administrator at or after grant; provided, however, that, except as provided herein or unless otherwise determined by the Administrator at or after grant, Stock Options shall become exercisable as to 25% of the shares subject to such Stock Option on the first anniversary of the date of grant of the Stock Option, and as to an additional 25% on each of the next three anniversaries of the date of grant. To the extent not exercised, installments

shall accumulate and be exercisable in whole or in part at any time after becoming exercisable but not later than the date the Stock Option expires. The Administrator may provide, in its discretion, that any Stock Option shall be exercisable only in installments, and the Administrator may waive such installment exercise provisions at any time in whole or in part based on such factors as the Administrator may determine, in its sole discretion.

(4) Method of Exercise. Subject to Section 5(3), Stock Options may be exercised in whole or in part at any time during the option period, by giving written notice of exercise to the Company specifying the number of shares to be purchased, accompanied by payment in full of the purchase price in cash or its equivalent as determined by the Administrator. As determined by the Administrator, in its sole discretion, payment in whole or in part may also be made in the form of unrestricted Stock already owned by the optionee, or, in the case of the exercise of a Non-Qualified Stock Option, Restricted Stock or Performance Shares subject to an award hereunder (based, in each case, on the Fair Market Value of the Stock on the date the option is exercised); provided, however, that in the case of an Incentive Stock Option, the right to make payment in the form of already owned shares may be authorized only at the time of grant. Any payment in the form of stock already owned by the optionee may be effected by use of an attestation form approved by the Administrator. If payment of the option exercise price of a Non-Qualified Stock Option is made in whole or in part in the form of Restricted Stock or Performance Shares, the shares received upon the exercise of such Stock Option (to the extent of the number of shares of Restricted Stock or Performance Shares surrendered upon exercise of such Stock Option) shall be restricted in accordance with the original terms of the Restricted Stock or Performance Share award in question, except that the Administrator may direct that such restrictions shall apply only to that number of shares equal to the number of shares surrendered upon the exercise of such option. An optionee shall generally have the rights to dividends and other rights of a stockholder with respect to shares subject to the option only after the optionee has given written notice of exercise, has paid in full for such shares, and, if requested, has given the representation described in paragraph (1) of Section 11.

The Administrator may require the voluntary surrender of all or a portion of any Stock Option granted under the Plan as a condition precedent to a grant of a new Stock Option. Subject to the provisions of the Plan, such new Stock Option shall be exercisable at the price, during such period and on such other terms and conditions as are specified by the Administrator at the time the new Stock Option is granted; provided, however, that should the Administrator so require, the number of shares subject to such new Stock Option shall not be greater than the number of shares subject to the surrendered Stock Option. Upon their surrender, Stock Options shall be canceled and the shares previously subject to such canceled Stock Options shall again be available for grants of Stock Options and other awards hereunder.

(5) Loans. The Company may make loans available to Stock Option holders in connection with the exercise of outstanding options granted under the Plan, as the Administrator, in its discretion, may determine. Such loans shall (i) be evidenced by promissory notes entered into by the Stock Option holders in favor of the Company, (ii) be subject to the terms and conditions set forth in this Section 5(5) and such other terms and conditions, not inconsistent with the Plan, as the Administrator shall determine, and (iii) bear interest, if any, at such rate as the Administrator shall determine. In no event may the principal amount of any such loan exceed the sum of (x) the exercise price less the par value of the shares of Stock covered by the option, or portion thereof, exercised by the holder, and (y) any federal, state, and local income tax attributable to such exercise.

The initial term of the loan, the schedule of payments of principal and interest under the loan, the extent to which the loan is to be with or without recourse against the holder with respect to principal or interest and the conditions upon which the loan will become payable in the event of the holder's termination of employment shall be determined by the Administrator; provided, however, that the term of the loan, including extensions, shall not exceed seven years. Unless the Administrator determines otherwise, when a loan is made, shares of Stock having a Fair Market Value at least equal to the principal amount of the loan shall be pledged by the holder to the Company as security for payment of the unpaid balance of the loan, and such pledge shall be evidenced by a pledge agreement, the terms of which shall be determined by the Administrator, in its discretion; provided, however, that each loan shall comply with all applicable laws, regulations and rules of the Board of Governors of the Federal Reserve System and any other governmental agency having jurisdiction.

(6) Limits on Transferability of Options.

(a) Subject to Section 5(6)(b), no Stock Option shall be transferable by the optionee otherwise than by will or by the laws of descent and distribution or pursuant to a "qualified domestic relations order," as such term is defined in the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and all Stock Options shall be exercisable, during the optionee's lifetime, only by the optionee or in accordance with the terms of a qualified domestic relations order.

(b) The Administrator may, in its discretion, authorize all or a portion of the options to be granted to an optionee to be on terms which permit transfer by such optionee to (i) the spouse, qualified domestic partner, children or grandchildren of the optionee and any other persons related to the optionee as may be approved by the Administrator ("Immediate Family Members"), (ii) a trust or trusts for the exclusive benefit of such Immediate Family Members, (iii) a partnership or partnerships in which such Immediate Family Members are the only partners, or (iv) any other persons or entities as may be approved by the Administrator, provided that (x) there may be no consideration for any transfer unless approved by the Administrator, (y) the stock option agreement pursuant to which such options are granted must be approved by the Administrator, and must expressly provide for transferability in a manner consistent with this Section 5(6)(b), and (z) subsequent transfers of transferred options shall be prohibited except those in accordance with Section 5(6)(a) or expressly approved by the Administrator. Following transfer, any such options shall continue to be subject to the same terms and conditions as were applicable immediately prior to transfer, provided that, except for purposes of Sections 5(7), (8), (9), (10) and 11(3) hereof, the terms "optionee," "Stock Option holder" and "Participant" shall be deemed to refer to the transferee. The events of termination of employment under Sections 5(7), (8) and (9) hereof shall continue to be applied with respect to the original optionee, following which the options shall be exercisable by the transferee only to the extent, and for the periods specified under such sections unless the option agreement governing such options otherwise provides. Notwithstanding the transfer, the original optionee will continue to be subject to the provisions of Section 11(3) regarding payment of taxes, including the provisions entitling the Company to deduct such taxes from amounts otherwise due to such optionee. Any transfer of a Stock Option that was originally granted with DERs related thereto shall automatically include the transfer of such DERs, any attempt to transfer such Stock Option separately from such DERs shall be void, and such DERs shall continue in effect according to their terms. "Qualified domestic partner" for the purpose of this Section 5(6)(b) shall mean a domestic partner living in the same household as the optionee and

registered with, certified by or otherwise acknowledged by the county or other applicable governmental body as a domestic partner or otherwise establishing such status in any manner satisfactory to the Administrator. Stock options granted prior to December 1, 1996 may be amended to provide for their transferability, subject to the foregoing conditions.

(7) Termination by Death. If an optionee's employment with the Company or any Subsidiary terminates by reason of death, the Stock Option may thereafter be immediately exercised, to the extent then exercisable (or on such accelerated basis as the Administrator shall determine at or after grant), by the legal representative of the estate or by the legatee of the optionee under the will of the optionee, for a period of twelve months (or such shorter period as the Administrator shall specify at grant) from the date of such death or until the expiration of the stated term of such Stock Option, whichever period is shorter.

(8) Termination by Reason of Disability. If an optionee's employment with the Company or any Subsidiary terminates by reason of Disability, any Stock Option held by such optionee may thereafter be exercised, to the extent it was exercisable at the time of such termination (or on such accelerated basis as the Administrator shall determine at the time of grant), for a period of twelve months (or such shorter period as the Administrator shall specify at grant) from the date of such termination of employment or until the expiration of the stated term of such Stock Option, whichever period is shorter; provided, however, that, if the optionee dies within such twelve-month period (or such shorter period as the Administrator shall specify at grant) and prior to the expiration of the stated term of such Stock Option, any unexercised Stock Option held by such optionee shall thereafter be exercisable to the extent to which it was exercisable at the time of termination for a period of twelve months (or such shorter period as the Administrator shall specify at grant) from the time of death or until the expiration of the stated term of such Stock Option, whichever period is shorter. In the event of a termination of employment by reason of Disability, if an Incentive Stock Option is exercised after the expiration of the applicable exercise periods under Section 422 of the Code, such Stock Option shall thereafter be treated as a Non-Qualified Stock Option.

(9) Other Termination. Except as otherwise determined by the Administrator, if an optionee's employment with the Company or any Subsidiary terminates for any reason other than death or Disability, the Stock Option may be exercised for a period of three months from the date of such termination, or until the expiration of the stated term of such Stock Option, whichever period is shorter.

(10) Annual Limit on Incentive Stock Options. To the extent that the aggregate Fair Market Value (determined as of the date the Incentive Stock Option is granted) of shares of Stock with respect to which Incentive Stock Options granted to an Optionee under this Plan and all other option plans of the Company, its Parent Corporation or any Subsidiary become exercisable for the first time by the Optionee during any calendar year exceeds $100,000, such Stock Options shall be treated as Non-Qualified Stock Options.

(11) DERs. The Administrator shall have the discretion to grant DERs in conjunction with grants of Stock Options pursuant to this Section 5. DERs may be granted in either of two forms, "Current-pay DERs" and "Accrued DERs" and the Administrator may condition the payment or accrual of amounts in respect thereof subject to satisfaction of such performance objectives as the Administrator may specify at the time of grant. Assuming satisfaction of any

applicable conditions, Current-pay DERs shall be paid concurrently with any dividends or distributions paid on the Stock during the time the related Stock Options are outstanding, or such portion of such time as the Administrator may determine, in an amount equal to the value of the cash dividend (or Stock or other property being distributed) per share being paid on the Stock times the number of shares subject to the related Stock Options. Current-pay DERs are payable in cash, Stock or other such property as may be distributed to stockholders, as the Administrator shall determine at the time of grant. Accrued DERs may be accrued in respect of cash dividends only or cash dividends and the value of any Stock or other property distributed to stockholders, as the Administrator shall determine at the time of grant. Assuming satisfaction of any applicable conditions, Accrued DERs shall be accrued with respect to the related Stock Options outstanding as of the date dividends are declared on the Company's Stock in accordance with the following formula:

$$(A \times B) / C$$

under which "A" equals the number of shares subject to such Stock Options, "B" equals the cash dividend per share or the value per share of the Stock or other property being distributed, as the case may be, and "C" equals the Fair Market Value per share of Stock on the dividend payment date. The Accrued DERs shall represent shares of Stock which shall be issuable to the holder of the related Stock Option proportionately as the holder exercises the Stock Option to which the Accrued DERs relate, rounded down to the nearest whole number of shares. DERs shall expire upon the expiration of the Stock Options to which they relate. The Administrator shall specify at the time of grant whether dividends shall be payable or credited on the shares of Stock represented by Accrued DERs. Notwithstanding anything to the contrary herein, Accrued DERs granted with respect to Stock Options shall be accrued only to the extent of the number of shares of stock then reserved and available for issuance under the Plan in excess of the number of shares subject to issuance pursuant to outstanding Stock Option, Accrued DER, Stock Appreciation Right, Limited Stock Appreciation Right, Deferred Stock or Performance Share Awards.

Section 5A. Stock Options For Eligible Non-Employee Directors.

This Section 5A shall apply only to automatic grants of Stock Options to Eligible Non-Employee Directors.

(1) Each Eligible Non-Employee Director shall automatically be granted, upon first becoming a director of the Company or any Subsidiary, a Non-Qualified Stock Option to purchase 5,000 shares of Stock, provided that no Eligible Non-Employee Director may receive more than one such grant for serving as a director of the Company and one or more Subsidiaries. In addition, on the day after the annual meeting of stockholders of the Company to be held in the calendar year 1998, and on the day after each annual stockholders' meeting of the Company thereafter during the term of the Plan, each Eligible Non-Employee Director of the Company shall be granted a Non-Qualified Stock Option to purchase such number of shares of Stock that the aggregate of the option prices thereof equals $20,000.00, rounded up to the nearest 100 shares. The option price per share of Stock purchasable under such Stock Option shall be 100% of the Fair Market Value on the date of grant. Such Stock Option shall become exercisable as to 25% of the shares subject to such Stock Option on the first anniversary of the date of grant of the Stock Option or such other date as the Board may approve, and as to an additional 25% of the shares subject to such Stock Option on each

of the next three anniversaries of the first vesting date. To the extent not exercised, installments shall accumulate and be exercisable in whole or in part at any time after becoming exercisable but not later than the date the Stock Option expires. Exercise shall be by payment in full of the purchase price in cash and no stock option shall be exercisable more than ten years after the date of grant. The aggregate number of shares of Stock that may be granted to Eligible Non-Employee Directors pursuant to the Plan may not exceed 180,000 shares.

(2) Eligible Non-Employee Directors who receive grants of Stock Options shall enter into a stock option agreement with the Company, which agreement shall set forth, among other things, the exercise price of the option, the term of the option and provisions regarding exercisability of the option granted thereunder. The Stock Options granted under this section shall be Non-Qualified Stock Options.

(3) Non-Qualified Stock Options granted to Eligible Non-Employee Directors hereunder shall be transferable only to the extent provided in Sections 5(6)(a) and (b).

(4) The Board may not amend, alter or discontinue the provisions of this Section 5A more than once every six months other than to comport with changes in the Code, ERISA or the rules thereunder.

Section 6. Stock Appreciation Rights and Limited Stock Appreciation Rights.

(1) Grant and Exercise. Stock Appreciation Rights and Limited Stock Appreciation Rights may be granted either alone (“Free Standing Rights”) or in conjunction with all or part of any Stock Option granted under the Plan (“Related Rights”). In the case of a Non-Qualified Stock Option, Related Rights may be granted either at or after the time of the grant of such Stock Option. In the case of an Incentive Stock Option, Related Rights may be granted only at the time of the grant of the Incentive Stock Option.

A Related Right or applicable portion thereof granted in conjunction with a given Stock Option shall terminate and no longer be exercisable upon the termination or exercise of the related Stock Option, except that, unless otherwise provided by the Administrator at the time of grant, a Related Right granted with respect to less than the full number of shares covered by a related Stock Option shall only be reduced if and to the extent that the number of shares covered by the exercise or termination of the related Stock Option exceeds the number of shares not covered by the Stock Appreciation Right.

A Related Right may be exercised by an optionee, in accordance with paragraph (2) of this Section 6, by surrendering the applicable portion of the related Stock Option. Upon such exercise and surrender, the optionee shall be entitled to receive an amount determined in the manner prescribed in paragraph (2) of this Section 6. Stock Options which have been so surrendered, in whole or in part, shall no longer be exercisable to the extent the Related Rights have been so exercised.

(2) Terms and Conditions. Stock Appreciation Rights shall be subject to such terms and conditions, not inconsistent with the provisions of the Plan, as shall be determined from time to time by the Administrator, including the following:

(a) Stock Appreciation Rights that are Related Rights ("Related Stock Appreciation Rights") shall be exercisable only at such time or times and to the extent that the Stock Options to which they relate shall be exercisable in accordance with the provisions of Section 5 and this Section 6; provided, however, that no Related Stock Appreciation Right shall be exercisable during the first six months of its term, except that this additional limitation shall not apply in the event of death or Disability of the optionee prior to the expiration of such six-month period.

(b) Upon the exercise of a Related Stock Appreciation Right, an optionee shall be entitled to receive up to, but not more than, an amount in cash or that number of shares of Stock (or in some combination of cash and shares of Stock) equal in value to the excess of the Fair Market Value of one share of Stock as of the date of exercise over the option price per share specified in the related Stock Option multiplied by the number of shares of Stock in respect of which the Related Stock Appreciation Right is being exercised, with the Administrator having the right to determine the form of payment.

(c) Related Stock Appreciation Rights shall be transferable or exercisable only when and to the extent that the underlying Stock Option would be transferable or exercisable under paragraph (6) of Section 5.

(d) Upon the exercise of a Related Stock Appreciation Right, the Stock Option or part thereof to which such Related Stock Appreciation Right is related shall be deemed to have been exercised for the purpose of the limitation set forth in Section 3 on the number of shares of Stock to be issued under the Plan.

(e) A Related Stock Appreciation Right granted in connection with an Incentive Stock Option may be exercised only if and when the Fair Market Value of the Stock subject to the Incentive Stock Option exceeds the exercise price of such Stock Option.

(f) Stock Appreciation Rights that are Free Standing Rights ("Free Standing Stock Appreciation Rights") shall be exercisable at such time or times and subject to such terms and conditions as shall be determined by the Administrator at or after grant; provided, however, that no Free Standing Stock Appreciation Right shall be exercisable during the first six months of its term, except that this limitation shall not apply in the event of death or Disability of the recipient of the Free Standing Stock Appreciation Right prior to the expiration of such six-month period.

(g) The term of each Free Standing Stock Appreciation Right shall be fixed by the Administrator, but no Free Standing Stock Appreciation Right shall be exercisable more than ten years after the date such right is granted.

(h) Upon the exercise of a Free Standing Stock Appreciation Right, a recipient shall be entitled to receive up to, but not more than, an amount in cash or that number of shares of Stock (or any combination of cash or shares of Stock) equal in value to the excess of the Fair Market Value of one share of Stock as of the date of exercise over the price per share specified in the Free Standing Stock Appreciation Right (which price shall be no less than 100% of the Fair

Market Value of the Stock on the date of grant) multiplied by the number of shares of Stock with respect to which the right is being exercised, with the Administrator having the right to determine the form of payment.

(i) Free Standing Stock Appreciation Rights shall be transferable or exercisable subject to the provisions governing the transferability and exercisability of Stock Options set forth in paragraphs (3) and (6) of Section 5.

(j) In the event of the termination of an employee who has been granted one or more Free Standing Stock Appreciation Rights, such rights shall be exercisable to the same extent that a Stock Option would have been exercisable in the event of the termination of the optionee.

(k) Limited Stock Appreciation Rights may only be exercised within the 30-day period following a “Change of Control” (as defined in Section 10 below), and, with respect to Limited Stock Appreciation Rights that are Related Rights (“Related Limited Stock Appreciation Rights”), only to the extent that the Stock Options to which they relate shall be exercisable in accordance with the provisions of Section 5 and this Section 6; provided, however, that no Related Limited Stock Appreciation Right shall be exercisable during the first six months of its term, except that this additional limitation shall not apply in the event of death or Disability of the optionee prior to the expiration of such six-month period.

(l) Upon the exercise of a Limited Stock Appreciation Right, the recipient shall be entitled to receive an amount in cash equal in value to the excess of the “Change of Control Price” (as defined in Section 10) of one share of Stock as of the date of exercise over (A) the option price per share specified in the related Stock Option, or (B) in the case of a Limited Stock Appreciation Right which is a Free Standing Stock Appreciation Right, the price per share specified in the Free Standing Stock Appreciation Right, such excess to be multiplied by the number of shares in respect of which the Limited Stock Appreciation Right shall have been exercised.

(m) For the purpose of the limitation set forth in Section 3 on the number of shares to be issued under the Plan, the grant or exercise of Free Standing Stock Appreciation Rights shall be deemed to constitute the grant or exercise, respectively, of Stock Options with respect to the number of shares of Stock with respect to which such Free Standing Stock Appreciation Rights were so granted or exercised.

Section 7. Restricted Stock, Deferred Stock and Performance Shares.

(1) General. Restricted Stock, Deferred Stock or Performance Share awards may be issued either alone or in addition to other awards granted under the Plan. The Administrator shall determine the Eligible Employees to whom, and the time or times at which, grants of Restricted Stock, Deferred Stock or Performance Share awards shall be made; the number of shares to be awarded; the price, if any, to be paid by the recipient of Restricted Stock, Deferred Stock or Performance Share awards; the Restricted Period (as defined in Section 7(3)) applicable to Restricted Stock or Deferred Stock awards; the performance objectives applicable to Performance Share or Deferred Stock awards; the date or dates on which restrictions applicable to such Restricted Stock or Deferred Stock awards shall lapse during such Restricted Period; and all other conditions of the Restricted Stock, Deferred Stock and Performance Share awards. The Administrator may also condition the grant of Restricted Stock, Deferred Stock awards or Performance Shares upon the

exercise of Stock Options, or upon such other criteria as the Administrator may determine, in its sole discretion. The provisions of Restricted Stock, Deferred Stock or Performance Share awards need not be the same with respect to each recipient.

(2) Awards and Certificates. The prospective recipient of a Restricted Stock, Deferred Stock or Performance Share award shall not have any rights with respect to such award, unless and until such recipient has executed an agreement evidencing the award (a "Restricted Stock Award Agreement," "Deferred Stock Award Agreement," or "Performance Share Award Agreement," as appropriate) and delivered a fully executed copy thereof to the Company, within a period of sixty days (or such other period as the Administrator may specify) after the award date. Except as otherwise provided below in this Section 7(2), (i) each Participant who is awarded Restricted Stock or Performance Shares shall be issued a stock certificate in respect of such shares of Restricted Stock or Performance Shares; and (ii) such certificate shall be registered in the name of the Participant, and shall bear an appropriate legend referring to the terms, conditions, and restrictions applicable to such award, substantially in the following form:

> "The transferability of this certificate and the shares of stock represented hereby are subject to the terms and conditions (including forfeiture) of the Redwood Trust, Inc. Amended and Restated 1994 Executive and Non-Employee Director Stock Option Plan and a Restricted Stock Award Agreement or Performance Share Award Agreement entered into between the registered owner and Redwood Trust, Inc. Copies of such Plan and Agreement are on file in the offices of Redwood Trust, Inc."

The Company shall require that the stock certificates evidencing such shares be held in the custody of the Company until the restrictions thereon shall have lapsed, and that, as a condition of any Restricted Stock award or Performance Share award, the Participant shall have delivered a stock power, endorsed in blank, relating to the Stock covered by such award.

(3) Restrictions and Conditions. The Restricted Stock, Deferred Stock and Performance Share awards granted pursuant to this Section 7 shall be subject to the following restrictions and conditions:

(a) Subject to the provisions of the Plan and the Restricted Stock, Deferred Stock or Performance Share award agreement, during such period as may be set by the Administrator commencing on the grant date (the "Restricted Period"), the Participant shall not be permitted to sell, transfer, pledge or assign shares of Restricted Stock, Performance Shares or Deferred Stock awarded under the Plan; provided, however, that the Administrator may, in its sole discretion, provide for the lapse of such restrictions in installments and may accelerate or waive such restrictions in whole or in part based on such factors and such circumstances as the Administrator may determine, in its sole discretion, including, but not limited to, the attainment of certain performance related goals, the Participant's termination, death or Disability or the occurrence of a "Change of Control" as defined in Section 10.

(b) Except as provided in paragraph (3)(a) of this Section 7, the Participant shall have, with respect to the shares of Restricted Stock or Performance Shares, all of the rights of a stockholder of the Company, including the right to vote the shares, and the right to receive any

dividends thereon during the Restricted Period. With respect to Deferred Stock awards, the Participant shall generally not have the rights of a stockholder of the Company, including the right to vote the shares during the Restricted Period; provided, however, that dividends declared during the Restricted Period with respect to the number of shares covered by a Deferred Stock award shall be paid to the Participant. Certificates for shares of unrestricted Stock shall be delivered to the Participant promptly after, and only after, the Restricted Period shall expire without forfeiture in respect of such shares covered by the award of Restricted Stock, Performance Shares or Deferred Stock, except as the Administrator, in its sole discretion, shall otherwise determine.

(c) Subject to the provisions of the Restricted Stock, Deferred Stock or Performance Share award agreement and this Section 7, upon termination of employment for any reason during the Restricted Period, all shares subject to any restriction as of the date of such termination shall be forfeited by the Participant, and the Participant shall only receive the amount, if any, paid by the Participant for such Restricted Stock or Performance Shares, plus simple interest on such amount at the rate of 8% per year.

Section 8. Amendment and Termination.

Subject to the provisions of Section 5A(5), the Board may amend, alter or discontinue the Plan, but no amendment, alteration, or discontinuation shall be made that would impair the rights of a Participant under any award theretofore granted without such Participant’s consent, or that without the approval of the stockholders (as described below) would:

(1) except as provided in Section 3, increase the total number of shares of Stock reserved for the purpose of the Plan;

(2) change the employees or class of employees eligible to participate in the Plan; or

(3) extend the maximum option period under paragraph (2) of Section 5 of the Plan.

Notwithstanding the foregoing, stockholder approval under this Section 8 shall only be required at such time and under such circumstances as stockholder approval would be required under Rule 16b-3 of the Act with respect to any material amendment to any employee benefit plan of the Company.

The Administrator may amend the terms of any award theretofore granted, prospectively or retroactively, but, subject to Section 3, no such amendment shall impair the rights of any holder without his or her consent.

Section 9. Unfunded Status of Plan.

The Plan is intended to constitute an “unfunded” plan for incentive compensation. With respect to any payments not yet made to a Participant or optionee by the Company, nothing contained herein shall give any such Participant or optionee any rights that are greater than those of a general creditor of the Company.

Section 10. Change of Control.

The following acceleration and valuation provisions shall apply in the event of a "Change of Control" as defined in paragraph (2) of this Section 10:

(1) In the event of a "Change of Control," unless otherwise determined by the Administrator or the Board in writing at or after grant (including under any individual agreement), but prior to the occurrence of such Change of Control:

(a) any Stock Appreciation Rights outstanding for at least six months and any Stock Options, including Stock Options granted under Section 5A, awarded under the Plan not previously exercisable and vested shall become fully exercisable and vested;

(b) the restrictions applicable to any Restricted Stock, Deferred Stock or Performance Share awards under the Plan shall lapse, and such shares and awards shall be deemed fully vested;

(c) any indebtedness incurred pursuant to Section 5(5) shall be forgiven and the collateral pledged in connection with any such loan shall be released; and

(d) the value of all outstanding Stock Options (except Stock Options granted under Section 5A), DERs (except DERs granted in conjunction with Stock Options granted under Section 5A), Stock Appreciation Rights, Limited Stock Appreciation Rights, and Restricted Stock, Deferred Stock and Performance Share awards shall, to the extent determined by the Administrator at or after grant, be cashed out by a payment in cash or other property, as the Administrator may determine, on the basis of the "Change of Control Price" (as defined in paragraph (3) of this Section 10) as of the date the Change of Control occurs or such other date as the Administrator may determine prior to the Change of Control.

(2) For purposes of paragraph (1) of this Section 10, a "Change of Control" shall be deemed to have occurred if:

(a) any "person," as such term is used in Sections 13(d) and 14(d) of the Act (other than the Company; any trustee or other fiduciary holding securities under an employee benefit plan of the Company; or any company owned, directly or indirectly, by the stockholders of the Company in substantially the same proportions as their ownership of Stock of the Company) is or becomes after the Effective Date the "beneficial owner" (as defined in Rule 13d-3 under the Act), directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 25% or more of the combined voting power of the Company's then outstanding securities; or

(b) during any period of two consecutive years (not including any period prior to the Effective Date), individuals who at the beginning of such period constitute the Board, and any new director (other than a director designated by a person who has entered into an agreement with the Company to effect a transaction described in clause (a), (c) or (d) of this Section 10(2)) whose election by the Board or nomination for election by the Company's stockholders was approved by a vote of at least two-thirds (2/3) of the directors then still in office who either were directors at the

beginning of the period or whose election or nomination for election was previously so approved, cease for any reason to constitute at least a majority thereof; or

(c) the stockholders of the Company approve a merger or consolidation of the Company with any other corporation, other than (A) a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity), in combination with the ownership of any trustee or other fiduciary holding securities under an employee benefit plan of the Company, at least 75% of the combined voting power of the voting securities of the Company or such surviving entity outstanding immediately after such merger or consolidation or (B) a merger or consolidation effected to implement a recapitalization of the Company (or similar transaction) in which no person acquires more than 50% of the combined voting power of the Company's then outstanding securities; or

(d) the stockholders of the Company approve a plan of complete liquidation of the Company or an agreement for the sale or disposition by the Company of all or substantially all of the Company's assets.

(3) For purposes of this Section 10, "Change of Control Price" means the higher of (i) the highest price per share paid or offered in any transaction related to a Change of Control of the Company or (ii) the highest price per share paid in any transaction reported on the exchange or national market system on which the Stock is listed, at any time during the preceding sixty day period as determined by the Administrator, except that, in the case of Incentive Stock Options and Stock Appreciation Rights or Limited Stock Appreciation Rights relating to Incentive Stock Options, such price shall be based only on transactions reported for the date on which the Administrator decides to cash out such options.

Section 11. General Provisions.

(1) The Administrator may require each person purchasing shares pursuant to a Stock Option to represent to and agree with the Company in writing that such person is acquiring the shares without a view to distribution thereof. The certificates for such shares may include any legend which the Administrator deems appropriate to reflect any restrictions on transfer.

All certificates for shares of Stock delivered under the Plan shall be subject to such stock-transfer orders and other restrictions as the Administrator may deem advisable under the rules, regulations, and other requirements of the Commission, any stock exchange upon which the Stock is then listed, and any applicable federal or state securities law, and the Administrator may cause a legend or legends to be placed on any such certificates to make appropriate reference to such restrictions.

(2) Nothing contained in the Plan shall prevent the Board from adopting other or additional compensation arrangements, subject to stockholder approval if such approval is required; and such arrangements may be either generally applicable or applicable only in specific cases. The adoption of the Plan shall not confer upon any employee of the Company or any

Subsidiary any right to continued employment with the Company or a Subsidiary, as the case may be, nor shall it interfere in any way with the right of the Company or a Subsidiary to terminate the employment of any of its employees at any time.

(3) Each Participant shall, no later than the date as of which the value of an award first becomes includable in the gross income of the Participant for federal income tax purposes, pay to the Company, or make arrangements satisfactory to the Administrator regarding payment of, any federal, state, or local taxes of any kind required by law to be withheld with respect to the award. The obligations of the Company under the Plan shall be conditional on the making of such payments or arrangements, and the Company (and, where applicable, its Subsidiaries) shall, to the extent permitted by law, have the right to deduct any such taxes from any payment of any kind otherwise due to the Participant.

(4) No member of the Board or the Administrator, nor any officer or employee of the Company acting on behalf of the Board or the Administrator, shall be personally liable for any action, determination, or interpretation taken or made in good faith with respect to the Plan, and all members of the Board or the Administrator and each and any officer or employee of the Company acting on their behalf shall, to the extent permitted by law, be fully indemnified and protected by the Company in respect of any such action, determination or interpretation.

Section 12. Effective Date of Plan.

The Plan became effective (the "Effective Date") on June 23, 1994, the date the Company's stockholders formally approved the Plan.

Section 13. Term of Plan.

No Stock Option, Stock Appreciation Right, Limited Stock Appreciation Right, Restricted Stock, Deferred Stock or Performance Share award shall be granted pursuant to the Plan on or after the tenth anniversary of the Effective Date, but awards theretofore granted may extend beyond that date.

Exhibit 11.1

Redwood Trust, Inc.
Computation of Per Share Earnings

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001
Basic:		
Average common shares outstanding	13,658,443	8,838,964
Total	13,658,443	8,838,964
Net Income	$11,218,789	$6,679,775
Per Share Amount	$ 0.82	$ 0.76
Diluted:		
Average common shares outstanding	13,658,443	8,838,964
Net effect of dilutive stock options outstanding during the period — based on the treasury stock method	418,962	226,257
Total	14,077,405	9,065,220
Net Income	$11,218,789	$6,679,775
Per Share Amount	$ 0.80	$ 0.74