
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: June 30, 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)*

**591 Redwood Highway, Suite 3100
Mill Valley, California**
(Address of principal executive offices)

68-0329422
*(I.R.S. Employer
Identification No.)*

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)
Common Stock (\$.01 par value)

902,068 as of August 14, 2002
15,743,032 as of August 14, 2002

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PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	June 30, 2002	December 31, 2001
	(Unaudited)	(In thousands, except share data)
ASSETS		
Residential mortgage loans	\$2,803,556	\$1,474,862
Residential credit-enhancement securities	284,759	190,813
Commercial mortgage loans	49,798	51,084
Securities portfolio	512,490	683,482
Cash and cash equivalents	13,155	9,030
Total Earning Assets	3,663,758	2,409,271
Restricted cash	113	3,399
Accrued interest receivable	17,544	13,729
Principal receivable	6,297	7,823
Other assets	2,070	1,422
Total Assets	\$3,689,782	\$2,435,644
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Short-term debt	\$1,005,003	\$ 796,811
Long-term debt, net	2,241,600	1,313,715
Accrued interest payable	2,924	2,569
Accrued expenses and other liabilities	9,848	6,498
Dividends payable	12,477	8,278
Total Liabilities	3,271,852	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; 15,624,012 and 12,661,749 issued and outstanding	156	127
Additional paid-in capital	401,513	328,668
Accumulated other comprehensive income	35,826	2,701
Cumulative earnings	86,344	59,961
Cumulative distributions to stockholders	(132,426)	(110,201)
Total Stockholders' Equity	417,930	307,773
Total Liabilities and Stockholders' Equity	\$3,689,782	\$2,435,644

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
(Unaudited) (In thousands, except share data)				
Interest Income				
Residential mortgage loans	\$ 19,601	\$ 16,263	\$ 33,726	\$ 35,965
Residential credit-enhancement securities	9,006	3,403	15,701	6,045
Commercial mortgage loans	1,233	1,961	2,507	3,894
Securities portfolio	6,222	16,562	14,736	33,610
Cash and cash equivalents	190	264	298	576
Total interest income	36,252	38,453	66,968	80,090
Interest Expense				
Short-term debt	(5,595)	(11,843)	(10,536)	(25,418)
Long-term debt	(12,894)	(15,167)	(23,555)	(33,005)
Total interest expense	(18,489)	(27,010)	(34,091)	(58,423)
Net Interest Income	17,763	11,443	32,877	21,667
Operating expenses	(4,536)	(3,378)	(8,082)	(6,358)
Other income (expense)	(789)	(508)	(1,332)	(664)
Net unrealized and realized market value gains (losses)	2,045	(413)	2,920	2,228
Net income before preferred dividend and change in accounting principle	14,483	7,144	26,383	16,873
Dividends on Class B preferred stock	(681)	(681)	(1,362)	(1,362)
Net income before change in accounting principle	13,802	6,463	25,021	15,511
Cumulative effect of adopting EITF 99-20 (See Note 2)	—	—	—	(2,368)
Net Income Available to Common Stockholders	\$ 13,802	\$ 6,463	\$ 25,021	\$ 13,143
Earnings per Share:				
Basic Earnings Per Share:				
Net income before change in accounting principle	\$ 0.91	\$ 0.73	\$ 1.73	\$ 1.75
Cumulative effect of adopting EITF 99-20	\$ —	\$ —	\$ —	\$ (0.27)
Net income	\$ 0.91	\$ 0.73	\$ 1.73	\$ 1.48
Diluted Earnings Per Share:				
Net income before change in accounting principle	\$ 0.88	\$ 0.70	\$ 1.68	\$ 1.70
Cumulative effect of adopting EITF 99-20	\$ —	\$ —	\$ —	\$ (0.26)
Net income	\$ 0.88	\$ 0.70	\$ 1.68	\$ 1.44
Weighted average shares of common stock and common stock equivalents:				
Basic	15,228,258	8,888,999	14,447,687	8,864,120
Diluted	15,747,048	9,184,195	14,920,053	9,121,108

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	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					
(Unaudited)									
(In thousands, except share data)									
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, March 31, 2002	902,068	\$26,517	14,624,647	\$ 146	\$ 374,854	\$ 11,015	\$ 71,861	\$ (119,949)	\$364,444
Comprehensive income:									
Net income before preferred dividend	—	—	—	—	—	—	14,483	—	14,483
Net unrealized income on assets available-for-sale	—	—	—	—	—	24,811	—	—	24,811
Total comprehensive income	—	—	—	—	—	—	—	—	39,294
Issuance of common stock	—	—	999,365	10	26,659	—	—	—	26,669
Dividends declared:									
Preferred	—	—	—	—	—	—	—	(681)	(681)
Common	—	—	—	—	—	—	—	(11,796)	(11,796)
Balance, June 30, 2002	902,068	\$26,517	15,624,012	\$ 156	\$ 401,513	\$ 35,826	\$ 86,344	\$ (132,426)	\$417,930

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
(Unaudited) (In thousands)				
Cash Flows From Operating Activities:				
Net income available to common stockholders before preferred dividend	\$ 14,483	\$ 7,144	\$ 26,383	\$ 14,505
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	1,121	2,319	4,452	3,610
Provision for credit losses	472	164	754	348
Non-cash stock compensation	61	108	103	251
Net unrealized and realized market value (gains) losses	(2,044)	413	(2,919)	(2,228)
Cumulative effect of adopting EITF 99-20	—	—	—	2,368
Net purchases of mortgage loans held-for-sale	(1,144,749)	(74,328)	(1,562,000)	(74,090)
Principal payments on mortgage loans held-for-sale	4,928	255	13,586	2,189
Net sales (purchases) of mortgage securities trading	29,259	162,753	19,355	(126,191)
Principal payments on mortgage securities trading	53,073	113,042	106,222	178,767
Net purchases of interest rate agreements	(123)	(115)	(123)	(773)
Net change in:				
Accrued interest receivable	(4,443)	2,317	(3,815)	2,851
Principal receivable	2,960	(3,920)	1,526	(1,371)
Other assets	(117)	(586)	(1,108)	308
Accrued interest payable	700	(151)	355	(1,065)
Accrued expenses and other liabilities	2,240	1,146	2,192	2,521
Net cash (used in) provided by operating activities	(1,042,179)	210,561	(1,395,037)	2,000
Cash Flows From Investing Activities:				
Purchases of mortgage loans held-for-investment	(470)	(100)	(635)	(100)
Proceeds from sales of mortgage loans held-for-investment	44,811	718	44,811	2,378
Principal payments on mortgage loans held-for-investment	84,707	86,617	173,847	147,396
Purchases of mortgage securities available-for-sale	(48,876)	(77,246)	(140,928)	(111,060)
Proceeds from sales of mortgage securities available-for-sale	28,440	1,772	88,971	4,806
Principal payments on mortgage securities available-for-sale	28,345	2,078	39,505	3,100
Net decrease in restricted cash	2,221	98	3,286	177
Net cash provided by investing activities	139,178	13,937	208,857	46,697
Cash Flows From Financing Activities:				
Net (repayments) borrowings on short-term debt	(117,510)	(131,371)	208,192	86,804
Proceeds from issuance of long-term debt	1,141,567	85	1,149,921	17,033
Repayments on long-term debt	(134,676)	(85,099)	(222,507)	(141,856)
Net proceeds from issuance of common stock	26,563	548	72,725	1,534
Dividends paid	(9,748)	(5,129)	(18,026)	(9,686)
Net cash provided by (used in) financing activities	906,196	(220,966)	1,190,305	(46,171)
Net increase in cash and cash equivalents	3,195	3,532	4,125	2,526
Cash and cash equivalents at beginning of period	9,960	14,477	9,030	15,483
Cash and cash equivalents at end of period	\$ 13,155	\$ 18,009	\$ 13,155	\$ 18,009
Supplemental disclosure of cash flow information:				
Cash paid for interest	\$ 17,789	\$ 27,991	\$ 33,736	\$ 60,321

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 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 June 30, 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 June 30, 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 six months ended June 30, 2002 are not necessarily indicative of the expected results for the year ended December 31, 2002.

The June 30, 2002 and 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 asset-backed securities (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.

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.

All significant intercompany balances and transactions with Sequoia and Holdings have been eliminated in the consolidation of the Company at June 30, 2002 and June 30, 2001. Certain amounts for prior periods have been reclassified to conform to the June 30, 2002 presentation.

Use of Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles (GAAP) 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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

differ from these 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 certain 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 June 30, 2002 and December 31, 2001, the Company had no impaired mortgage loans.

EITF 99-20. 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* which established new income and impairment recognition standards for certain interests in 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 may be 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 loss through the income statement. These 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 provisions of *EITF 99-20* became 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 six months ended June 30, 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.*

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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. Management has prepared these financial statements in accordance with GAAP and 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*. Coupon 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 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. Unrealized losses on these securities as a result of EITF 99-20 adjustments are reported as a component of Net Unrealized and Realized Market Value Gains (Losses) in the Consolidated Statements of Operations.

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,

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

and interest rates. For Residential Credit-Enhancement Securities purchased at a discount, a portion of the discount for each security may be 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 under the provisions of EITF 99-20. 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 over time.

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 or securities 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 June 30, 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. At June 30, 2002, the Company's

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Interest Rate Agreements are included in Accrued Expenses and Other Liabilities on the Consolidated Balance Sheets.

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 currently 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.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
(In thousands, except share data)				
Numerator:				
Numerator for basic and diluted earnings per share —				
Net income before preferred dividend and change in accounting principle	\$ 14,483	\$ 7,144	\$ 26,383	\$ 16,873
Cash dividends on Class B preferred stock	(681)	(681)	(1,362)	(1,362)
Net income before change in accounting principle	13,802	6,463	25,021	15,511
Cumulative effect of adopting EITF 99-20	—	—	—	(2,368)
Basic and Diluted EPS — Net income available to common stockholders	\$ 13,802	\$ 6,463	\$ 25,021	\$ 13,143
Denominator:				
Denominator for basic earnings per share				
Weighted average number of common shares outstanding during the period	15,228,258	8,888,999	14,447,687	8,864,120
Net effect of dilutive stock options	518,790	295,196	472,366	256,988
Denominator for diluted earnings per share	15,747,048	9,184,195	14,920,053	9,121,108
Basic Earnings Per Share:				
Net income before change in accounting principle	\$ 0.91	\$ 0.73	\$ 1.73	\$ 1.75
Cumulative effect of adopting EITF 99-20	—	—	—	(0.27)
Net income per share	\$ 0.91	\$ 0.73	\$ 1.73	\$ 1.48
Diluted Earnings Per Share:				
Net income before change in accounting principle	\$ 0.88	\$ 0.70	\$ 1.68	\$ 1.70
Cumulative effect of adopting EITF 99-20	—	—	—	(0.26)
Net income per share	\$ 0.88	\$ 0.70	\$ 1.68	\$ 1.44

The number of common equivalent shares issued by the Company that were anti-dilutive during the three months ended June 30, 2002 totaled 400,762.

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 June 30, 2002 and December 31, 2001, the only component of Accumulated Other Comprehensive Income was net unrealized gains and losses on assets available-for-sale.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Recent Accounting Pronouncements

In May 2002, the FASB issued SFAS No. 145, "*Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*." SFAS 145 rescinds the automatic treatment of gains or losses from extinguishment of debt as extraordinary unless they meet the criteria for extraordinary items as outlined in APB Opinion No. 30, "*Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*". In addition, SFAS 145 also requires sale-leaseback accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions and makes various technical corrections to existing pronouncements. The provisions of this statement related to the rescission of FASB Statement 4 shall be applied in fiscal years beginning after May 15, 2002. The provisions in paragraphs 8 and 9(c) of this Statement related to FASB Statement 13 shall be effective for transactions occurring after May 15, 2002, with early application encouraged. All other provisions of this Statement shall be effective for financial statements issued on or after May 15, 2002. The Company believes that the adoption of SFAS No. 145 will not have a material effect on its financial position or results of operations.

In July 2002, the FASB issued SFAS No. 146, "*Accounting for Costs Associated with Exit or Disposal Activities*" (SFAS 146). SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "*Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*." This Statement requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002. The Company believes that the adoption of SFAS No. 146 will not have a material effect on its financial position or results of operations.

Note 3. Earning Assets

At June 30, 2002 and December 31, 2001, investments in Earning Assets generally consisted of interests in adjustable-rate, hybrid, and 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.

For the three and six months ended June 30, 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 4.71% and 4.80%, and 7.18% and 7.45%, respectively, based on the reported carrying value of the assets. For the three and six months ended June 30, 2002, the average balance of Earning Assets was \$3.1 billion and \$2.8 billion, respectively. For both the three and six months ended June 30, 2001, the average balance of Earning Assets was \$2.1 billion.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

At June 30, 2002 and December 31, 2001, Earning Assets consisted of the following:

Residential Mortgage Loans

(in thousands)

	June 30, 2002			December 31, 2001		
	Held-for-Sale	Held-for-Investment	Total	Held-for-Sale	Held-for-Investment	Total
Current Face	\$608,476	\$2,187,152	\$2,795,628	\$153,125	\$1,317,343	\$1,470,468
Unamortized Discount	(320)	—	(320)	(364)	(132)	(496)
Unamortized Premium	2,731	11,470	14,201	34	10,055	10,089
Amortized Cost	610,887	2,198,622	2,809,509	152,795	1,327,266	1,480,061
Reserve for Credit Losses	—	(5,953)	(5,953)	—	(5,199)	(5,199)
Carrying Value	\$610,887	\$2,192,669	\$2,803,556	\$152,795	\$1,322,067	\$1,474,862

At June 30, 2002 and December 31, 2001, residential mortgage loans with a net carrying value of \$610 million and \$148 million were pledged as collateral under short-term borrowing arrangements to third parties, respectively.

Residential Credit-Enhancement Securities

(in thousands)

	June 30, 2002 Mortgage Securities Available-for-Sale	December 31, 2001 Mortgage Securities Available-for-Sale
Current Face	\$ 492,642	\$ 353,435
Unamortized Discount	(35,745)	(25,863)
Portion Of Discount Designated As A Credit Reserve	(206,343)	(140,411)
Amortized Cost	250,554	187,161
Gross Unrealized Gains	35,563	7,174
Gross Unrealized Losses	(1,358)	(3,522)
Carrying Value	\$ 284,759	\$ 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 \$66 billion and \$52 billion of loans securitized by third parties at June 30, 2002 and December 31, 2001, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

When the Company purchases residential credit enhancement interests, a portion of the discount for each security may be 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 may 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 June 30, 2002 and December 31, 2001, the Company designated \$206 million and \$140 million, respectively, as a credit reserve on its residential credit-enhancement interests. The credit reserves are specific to each residential credit-enhancement interest.

At June 30, 2002 and December 31, 2001, Residential Credit-Enhancement Securities with a net carrying value of \$75 million and \$89 million, respectively, were pledged as collateral under borrowing arrangements to third parties.

Commercial Mortgage Loans

(in thousands)

	June 30, 2002			December 31, 2001		
	Held-for-Sale	Held-for-Investment	Total	Held-for-Sale	Held-for-Investment	Total
Current Face	\$19,231	\$31,205	\$50,436	\$30,931	\$20,860	\$51,791
Unamortized Discount	(532)	(106)	(638)	(683)	(24)	(707)
Carrying Value	\$18,699	\$31,099	\$49,798	\$30,248	\$20,836	\$51,084

At June 30, 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 June 30, 2002 and December 31, 2001, commercial mortgage loans held-for-investment with a net

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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)

	June 30, 2002			December 31, 2001		
	Securities Portfolio Trading	Securities Portfolio Available-for-Sale	Total	Securities Portfolio Trading	Securities Portfolio Available-for-Sale	Total
Current Face	\$295,911	\$206,773	\$502,684	\$501,078	\$171,877	\$672,955
Unamortized Discount	(385)	(1,472)	(1,857)	(139)	(1,320)	(1,459)
Unamortized Premium	3,698	6,343	10,041	6,634	6,303	12,937
Amortized Cost	299,224	211,644	510,868	507,573	176,860	684,433
Gross Unrealized Gains	—	1,929	1,929	—	516	516
Gross Unrealized Losses	—	(307)	(307)	—	(1,467)	(1,467)
Carrying Value	\$299,224	\$213,266	\$512,490	\$507,573	\$175,909	\$683,482
Agency	\$236,084	\$ 0	\$236,084	\$353,523	\$ 20,223	\$373,746
Non-Agency	63,140	213,266	276,406	154,050	155,686	309,736
Carrying Value	\$299,224	\$213,266	\$512,490	\$507,573	\$175,909	\$683,482

For the three and six months ended June 30, 2002, the Company recognized net market value gains through the Consolidated Statement of Operations of \$0.7 million and \$1.5 million on its securities portfolio, respectively. For the three and six months ended June 30, 2001, the Company recognized net market value losses of \$0.4 million and net market value gains of \$0.4 million, respectively, through the Consolidated Statement of Operations on its securities portfolio.

At June 30, 2002 and December 31, 2001, securities portfolio assets with a net carrying value of \$458 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 June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Balance at beginning of period	\$5,481	\$4,968	\$5,199	\$4,814
Provision for credit losses	472	164	754	348
Charge-offs	—	(12)	—	(42)
Balance at end of period	\$5,953	\$5,120	\$5,953	\$5,120

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 5. Interest Rate Agreements

Through June 30, 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. As of June 30, 2002 and December 31, 2001, the fair value of the Company's Interest Rate Agreements was negative \$1.2 million and \$0, respectively. At June 30, 2002, the Company's Interest Rate Agreements are included in Accrued Expenses and Other Liabilities on the Consolidated Balance Sheets.

During both the three and six months ended June 30, 2002, the Company recognized net market value losses of \$1.3 million on Interest Rate Agreements. During the three and six months ended June 30, 2001, the Company recognized net market value gains of \$0.1 million and net market value losses of \$0.4 million, respectively, 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 and in the Company's specific assets and liabilities. 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 June 30, 2002 and December 31, 2001, the Company had two interest rate caps with strike rates based on the one-month London Interbank Offered Rate (LIBOR) interest rate ranging from 6.25% to 7.00% expiring in 2002 and 2003 and two generally offsetting interest rate swaps between Redwood Trust, Sequoia and a third party financial institution. At June 30, 2002, the Company had four interest rate swap agreements with third party financial institutions which paid a fixed interest rate and received three-month LIBOR interest rate. At June 30, 2002 and December 31, 2001, the two generally offsetting interest rate swaps had gross notional amounts of \$407 million and \$445 million, respectively. The four interest rate swap agreements with third party financial institutions had notional amounts totalling \$129 million at June 30, 2002.

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 June 30, 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 swap between Redwood and the third party financial institution required Redwood to provide collateral in the form of agency securities of \$6.6 million at both June 30, 2002 and December 31, 2001. Sequoia did not hold collateral of the third party financial institution for its swap at June 30, 2002 or December 31, 2001. The cash and collateral held by counterparties are included in Restricted Cash or the Securities Portfolio on the Consolidated Balance Sheets.

(in thousands)

	Notional Amounts		Credit Exposure	
	June 30, 2002	December 31, 2001	June 30, 2002	December 31, 2001
Interest Rate Caps Purchased	\$ 8,000	\$ 313,000	—	—
Interest Rate Swaps	535,684	445,107	\$6,563	\$ 6,645
Total	\$543,684	\$ 758,107	\$6,563	\$ 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 may 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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 generally enters 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 a portion of its Earning Assets.

At June 30, 2002, the Company had \$1.0 billion of Short-Term Debt outstanding with a weighted-average borrowing rate of 2.21% and a weighted-average remaining maturity of 124 days. This debt was collateralized with \$1.1 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 June 30, 2002 and December 31, 2001, the Short-Term Debt had the following remaining maturities:

(in thousands)	June 30, 2002	December 31, 2001
Within 30 days	\$ 363,944	\$ 270,855
31 to 90 days	28,627	226,407
Over 90 days	612,432	299,549
Total Short-Term Debt	<u>\$1,005,003</u>	<u>\$ 796,811</u>

For both the three and six months ended June 30, 2002, the average balance of Short-Term Debt was \$0.9 billion, with a weighted-average interest cost of 2.37% and 2.25%, respectively. For both the three and six months ended June 30, 2001, the average balance of Short-Term Debt was \$0.9 billion, with a weighted-average interest cost of 4.82% and 5.35%, respectively. The maximum balance outstanding during both the three and six months ended June 30, 2002 was \$1.2 billion. The maximum balance outstanding during both the three and six months ended June 30, 2001 was \$1.0 billion. At June 30, 2002 and December 31, 2001, the Company continues to be in compliance with all of its debt covenants for all its short-term borrowing arrangements and credit facilities.

At June 30, 2002 and December 31, 2001, 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, as well as pursue additional facilities and other types of financings.

At June 30, 2002, the Company also had short-term facilities with three Wall Street Firms totaling \$1.4 billion to fund Residential Mortgage Loans. At December 31, 2001, the Company had short-term facilities with two Wall Street Firms totaling \$1.0 billion to fund Residential Mortgage Loans. At June 30, 2002 and December 31, 2001, the Company had borrowings under these facilities of \$592 million and \$146 million, respectively. Borrowings under these facilities bear interest based on a specified margin over the one-month LIBOR interest rate. At June 30, 2002 and December 31, 2001, the weighted average borrowing rate under these facilities was 2.35% and 2.56%, respectively. These facilities expire between March 2003 and June 2003.

At June 30, 2002 and December 31, 2001, the Company had two committed revolving mortgage warehousing credit facilities totaling \$57 million to finance commercial mortgage loans. At June 30, 2002, the Company had no borrowings under these facilities. At December 31, 2001, the Company had borrowings

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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. These facilities expire in July 2002 and September 2002.

At June 30, 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. In addition to these committed facilities, the Company may also finance securities with lower than investment grade ratings through non-committed borrowing arrangements. At June 30, 2002 and December 31, 2001, the Company had borrowings under its committed and non-committed facilities of \$52 million and \$66 million, respectively. Borrowings under these facilities bear interest based on a specified margin over the one-month LIBOR interest rate. At June 30, 2002 and December 31, 2001, the weighted average borrowing rate under these facilities was 2.91% and 2.92%, respectively. Two of the committed facilities expire in September 2002, and a third expires in February 2003. The fourth committed 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 securitizations, the Company issues Residential Long-Term Debt in the form of asset-backed securities secured by Residential Mortgage Loans (Residential Bond Collateral). The Residential Bond Collateral consists primarily of adjustable-rate and hybrid, conventional, 25 or 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 governing documents 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 governing documents. 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.

During the second quarter of 2002, the Company issued \$80 million of Long-Term Debt secured by Residential Mortgage Securities with stated maturities of 2029 and 2030. The maturity of this Long-Term Debt is directly affected by the rate of principal prepayments on the related Residential Mortgage Securities. As a result, the actual maturity of any class of this Long-Term Debt 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.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

(in thousands)

	June 30, 2002	December 31, 2001
Residential Mortgage Loans:		
Residential Mortgage Loans held-for-sale	\$ 944	\$ 848
Residential Mortgage Loans held-for-investment	2,192,669	1,322,067
Residential Mortgage Securities available-for-sale	77,426	—
Restricted cash	66	2,534
Accrued interest receivable	6,911	5,340
Total Residential Collateral	\$2,278,016	\$1,330,789
Commercial Mortgage Loans held-for-investment	\$ 31,099	\$ 20,836
Total Long-Term Debt Collateral	\$2,309,115	\$1,351,625

The components of the Long-Term Debt at June 30, 2002 and December 31, 2001 along with selected other information are summarized below:

(in thousands)

	June 30, 2002	December 31, 2001
Residential Long-Term Debt	\$ 2,221,135	\$ 1,297,958
Commercial Long-Term Debt	25,637	17,211
Unamortized premium on Long-Term Debt	1,741	2,038
Deferred bond issuance costs	(6,913)	(3,492)
Total Long-Term Debt	\$ 2,241,600	\$ 1,313,715
Range of weighted-average interest rates, by series — residential	2.16% to 6.77%	2.28% to 6.35%
Stated residential maturities	2024 – 2032	2024 – 2029
Number of residential series	7	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 and six months ended June 30, 2002, the average balance of Residential Long-Term Debt was \$1.8 billion and \$1.5 billion, respectively. For both the three and six months ended June 30, 2001, the average balance of Residential Long-Term Debt was \$1.0 billion. For the three and six months ended June 30, 2002, 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 2.81% and 3.01%, respectively. For the three and six months ended June 30, 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 5.96% and 6.32%, respectively. At both June 30, 2002 and December 31, 2001, accrued interest payable on Residential Long-Term Debt was \$1.9 million, and is reflected as a component of Accrued Interest Payable on the Consolidated Balance Sheets.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

At June 30, 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 and six months ended June 30, 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 and six months ended June 30, 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 June 30, 2002 and December 31, 2001. At June 30, 2002 and December 31, 2001, the deferred tax assets and associated valuation allowances were approximately \$9.2 million and \$9.3 million, respectively. At June 30, 2002 and December 31, 2001, Holdings had net operating loss carryforwards of approximately \$24.1 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 June 30, 2002 and December 31, 2001.

(in thousands)

	June 30, 2002		December 31, 2001	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Mortgage Loans				
Residential: held-for-sale	\$ 609,942	\$ 609,942	\$ 152,795	\$ 152,795
Residential: held-for-investment	2,193,614	2,197,335	1,322,067	1,318,673
Commercial: held-for-sale	18,699	18,699	30,248	30,248
Commercial: held-for-investment	31,099	31,099	20,836	20,860
Mortgage Securities				
Residential: trading	299,224	299,224	507,573	507,573
Residential: available-for-sale	498,025	498,025	366,722	366,722
Liabilities				
Short-Term Debt	1,005,003	1,005,003	796,811	796,811
Long-Term Debt	2,241,600	2,260,425	1,313,715	1,295,323

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 June 30, 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 and six months ended June 30, 2002 and 2001. At June 30, 2002, there remained 142,550 shares available under the authorization for repurchase.

Stock Option Plan

In March 2002, the Company adopted an Incentive Stock Plan for executive officers, employees, and non-employee directors (the Plan) which was approved by the Company's shareholders in May 2002. 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 Plan has been designed to permit the Company's compensation committee to grant and certify awards which qualify as performance-based and otherwise satisfy the requirements of Section 162(m) of the Code, however not all awards may so qualify. This plan replaced the Company's prior stock option plan. At June 30, 2002 and December 31, 2001, 676,116 and 299,064 shares of Common Stock, respectively, were available for grant.

Of shares of Common Stock available for grant, no more than 963,637 shares of Common Stock are cumulatively available for grant as ISOs. At June 30, 2002 and December 31, 2001, 463,937 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.

As of December 31, 2001, 28,000 shares of restricted stock had been granted to two officers of the Company. At June 30, 2002, restrictions on 8,750 of these shares had lapsed. The restrictions on the remaining 19,250 shares lapse in equal increments on the first day of each calendar quarter from July 1, 2002 through January 1, 2005. As of June 30, 2002, no other restricted shares had been awarded.

The Company has granted certain 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, stock and cash DER expenses may increase. For the three and six months ended June 30, 2002, the Company accrued cash and stock DER expenses of \$1.7 million and \$2.9 million, respectively. For the three and six months ended June 30, 2001, the Company accrued cash and

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

stock DER expenses of \$1.0 million and \$1.7 million, respectively. Stock and cash DERs are 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 causing the underlying stock options to be considered variable stock awards under the provisions of Accounting Principles Board Opinion 25. In addition to the stock DER expense on these options, for the three and six months ended June 30, 2002, the Company recognized variable stock option expense of \$0.8 million and \$1.3 million, respectively. For the three and six months ended June 30, 2001, the Company recognized variable stock option expense of \$0.5 million and \$0.7 million, respectively. Variable stock option expense is included in Other Income (Expense) on the Consolidated Statement of Operations.

The number of stock DER shares accrued are 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 June 30, 2002 and December 31, 2001, there were 187,031 and 181,010 unexercised options with stock DERs under the Plan, respectively. Cash DERs are accrued and paid based on the level of the Company's common stock dividend. At June 30, 2002 and December 31, 2001, there were 1,295,479 and 1,284,222 unexercised options with cash DERs under the Plan, respectively. At June 30, 2002 and December 31, 2001, there were 150,410 and 153,269, respectively, outstanding stock options that did not have DERs.

A summary of the status of the Plan at June 30, 2002 and changes during the three and six months ended is presented below.

(in thousands, except share data)

	Three Months Ended June 30, 2002		Six Months Ended June 30, 2002	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding options at beginning of period	1,620,606	\$ 22.29	1,618,501	\$ 22.33
Options granted	17,300	\$ 28.82	17,900	\$ 28.75
Options exercised	(10,456)	\$ 17.18	(12,078)	\$ 17.24
Options canceled	—	—	(1,029)	\$ 14.34
Dividend equivalent rights earned	5,470	—	9,626	—
Outstanding options at end of period	1,632,920	\$ 22.31	1,632,920	\$ 22.31

Employee Stock Purchase Plan

In May 2002, the Company's common shareholders approved the Employee Stock Purchase Plan (ESPP). The ESPP will allow eligible employees to purchase, beginning July 1, 2002, 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.

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 and six months ended June 30, 2002 and 2001. At June 30, 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.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Common Stock Issuances

In February and April 2002, the Company completed secondary offerings of 1,725,000 and 575,000 shares of common stock for net proceeds of \$40.3 million and \$14.9 million, respectively. The Company also issued 414,621 and 653,740 shares of common stock, through its Dividend Reinvestment and Stock Purchase Plan for net proceeds of \$11.5 million and \$17.5 million, respectively, during the three and six months ended June 30, 2002.

Note 11. Commitments and Contingencies

At June 30, 2002, the Company had entered into commitments to purchase \$5 million of securities and \$99 million of residential mortgage loans for settlement in July 2002.

At June 30, 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 \$2.3 million and are expected to be expensed as follows: 2002 — \$0.4 million; 2003 — \$0.6 million; 2004 — \$0.6 million; 2005 — \$0.5 million; 2006 — \$0.2 million.

Note 12. Subsequent Events

In July 2002, the Company issued \$634 million in face value of Long-Term Debt through Sequoia Mortgage Trust 8. 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 August 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 third quarter of 2002. The Board of Directors also declared a preferred cash dividend of \$0.755 per share for the third quarter of 2002. The common and preferred cash dividends are payable on October 21, 2002 to shareholders of record on September 30, 2002.

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 and our Prospectus Supplement dated April 23, 2002. 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. It is not practicable to publish all such revisions and, as a result, no one should assume that results or trends 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

Summary and Outlook

In the first half of 2002, we acquired \$1.6 billion high-quality residential mortgage loans, \$0.6 million commercial mortgage loans, \$85 million residential credit enhancement securities, and \$100 million real estate securities. This growth was funded with new equity (sourced through two equity offerings and our direct stock purchase and dividend reinvestment program) and with new issuance of non-recourse long-term debt. We continued to reduce our reliance on short-term debt: short-term debt declined from 37% of our liabilities to 31% of our liabilities in the first half of 2002. Our new product initiatives in high-quality commercial real estate finance and in diverse of types of investment-grade real estate securities (under accumulation for collateral for a potential issuance of Collateralized Bond Obligation debt) continue to move along at a deliberate pace. We have significantly increased our staff, and continue to make material investments in building our operating capabilities and expertise. While our operating expenses are increasing, they have increased at a much slower rate than our business has grown — our operations have become more capable while also becoming more productive. Our credit results remain excellent and our asset/liability posture remains well balanced.

Our GAAP earnings were \$0.88 per share in the second quarter of 2002, an increase from the \$0.80 we reported in the first quarter of 2002 and an increase from \$0.70 per share in the second quarter of 2001. For the first half of 2002, our GAAP earnings were \$1.68 per share, an increase from the \$1.44 per share we reported in the first half of 2001.

Core earnings were \$0.80 per share for the second quarter of 2002, an increase from the \$0.77 we reported in the first quarter of 2002 and the same as the \$0.80 per share we reported in the second quarter of 2001. Our core earnings totaled \$1.57 per share in the first half of 2002, an increase over the \$1.53 per share we reported in the first half of 2001. Core earnings equal GAAP earnings excluding mark-to-market adjustments and non-recurring items. We believe that core earnings is a useful additional measure of on-going income and cash flow

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generation at Redwood: unlike GAAP, core earnings does not include changes in asset market values (which can fluctuate significantly from quarter to quarter and which do not affect our cash flows). See Table 1 for a detailed reconciliation of GAAP earnings and core earnings.

Net interest income as a percentage of equity is, in our opinion, the best measure of the profitability rate of our real estate mortgage portfolios. This measure has remained between 17% and 21% throughout 2001 and 2002, and was 19% in the second quarter of 2002. Last year, we benefited on a temporary basis from an extraordinary drop in short-term interest rates. As we move through 2002, the benefits from last year's interest rate changes have been diminishing. At the same time, in 2002, our portfolio profitability has been enhanced by continued favorable changes in asset mix (additional credit-related assets as opposed to AAA rated securities) and by increases in returns from our credit-related investments (due to excellent credit results and faster prepayment rates). As a result of these offsetting trends in 2002 (diminished interest rate related earnings, increased credit related earnings), our portfolio profitability in 2002 has been consistent with our results in 2001.

Operating expenses as a percentage of equity is, in our opinion, the best measure of operating cost efficiency for our company. Although this measure varies from quarter to quarter — due to factors such as equity offerings and variable compensation expense accruals tied to earnings and dividends — the general trend has been towards greater productivity. Operating expenses as a percentage of equity improved from 6.1% in the second quarter of 2001 to 4.9% in the second quarter of 2002.

Our return on equity (annualized core earnings as a percentage of average common equity) has generally remained stable, remaining in the 13% to 15% range throughout 2001 and 2002. It was 14.5% in second quarter of 2002.

We believe the outlook for our business remains favorable. Our short-term earnings can vary from quarter to quarter due to fluctuations in interest rates, prepayment rates, asset market values, and other factors; however, we believe we are well balanced from an asset/liability management perspective and we believe that it is unlikely that fluctuations in these short-term factors will alter the returns Redwood can generate over the long-term.

We believe the key longer-term trends for our business are the strength of our credit results and the strength of our competitive market position.

Our credit losses remain under 0.01% of our residential portfolios on an annualized basis. In addition, in many parts of the country, housing prices have increased. This reduces our risk of future loss. As a result of these favorable credit trends (and faster prepayments), we are recognizing more income under the effective yield method from our residential credit-enhancement portfolio. (We calculate long-term GAAP yields for many of our assets using long-term assumptions about prepayments, the amount of future credit losses over the life of the mortgage, and the timing of losses. For many of our more seasoned assets, we have increased the yield we are recognizing for GAAP purposes, as — relative to our initial assumptions — our current estimate of the likely long-term prepayment rate has increased, our estimate of total life-of-the-mortgage credit losses has decreased, and/or our estimate of the likely timing of credit losses has been extended to later years). We have also reduced our expense rate for credit provisions for the more seasoned portions of our loan portfolios. If favorable credit results, risk reduction through increasing housing prices, and faster prepayment rates continue, we will continue to increase our estimates of the long-term cash flows we will receive from these assets — and will thus recognize increased yields on our credit-enhancement portfolio and reduced credit provision expense rates on our loan portfolios. However, the economy is still weak, the stock market is falling, deflationary forces are still evident, and some observers believe that housing prices are vulnerable. A reversal of our current favorable credit trends remains a real possibility. If this occurs, the asset yields we recognize into income would decline and/or we would incur a mark-to-market expense under EITF 99-20. We monitor relevant market trends continuously, and will continue to revise the long-term assumptions that go into our GAAP yield calculations and credit provisions.

We believe our competitive position remains strong. We believe we have an efficient balance sheet combined with good economies of scale, strong capabilities, and a strong market position. We have recently

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noted an increase in competition in the form of increased demand for residential whole loans from banks, increased demand for residential credit-enhancement securities from specialized investors, and an increase in demand for investment-grade real estate securities from corporate bond buyers and investment managers accumulating collateral for Collateralized Bond Obligation (CBO) issuances. This increased demand for assets has increased prices for some of the assets we generally seek to acquire. These price increases do not affect cash flows from our current assets. Given what we believe to be our strong competitive position, we believe we will continue to be able to acquire and fund new real estate debt assets on an attractive basis. For some mortgage products, however, our rate of acquisition may slow. Currently, we do not see this increase in demand by other investors for mortgage assets as a material long-term issue for us, but it could eventually become one if the trend intensifies and continues over a period of several years.

Our first goal in managing Redwood'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 that our current regular quarterly dividend rate of \$0.63 per common share is more likely than not to be sustainable, given current expectations for cash flow generation and other factors, unless we encounter stressful conditions.

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 a year. We declared a special dividend of \$0.125 per common share for both the second and third quarters of 2002.

Reconciliation of GAAP Income and Core Income

The table below reconciles GAAP earnings to core earnings.

Table 1

**GAAP Earnings and Core Earnings
(all dollars in thousands)**

	GAAP Earnings	Asset Mark-to-Market Adjustments	Variable Stock Option Mark-to-Market Adjustments	Core Earnings	Average Diluted Shares	GAAP Earnings Per Share	Core Earnings Per Share
Q2: 2001	\$ 6,463	\$ (413)	\$ (508)	\$ 7,384	9,184,195	\$ 0.70	\$ 0.80
Q3: 2001	8,065	104	(227)	8,188	10,752,062	0.75	0.76
Q4: 2001	8,955	(800)	(20)	9,775	12,888,420	0.69	0.76
Q1: 2002	11,219	875	(543)	10,887	14,077,405	0.80	0.77
Q2: 2002	13,802	2,045	(789)	12,546	15,747,048	0.88	0.80
Six Months: 2001	\$13,143	\$ (140)	\$ (664)	\$13,947	9,121,108	\$ 1.44	\$ 1.53
Six Months: 2002	25,021	2,920	(1,332)	23,433	14,920,053	1.68	1.57

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 \$17.8 million in the second quarter of 2002 from \$15.1 million in the first quarter of 2002 and \$11.4 million in the second quarter of 2001. Growth in net interest income generally tracked increases in our equity base and net employed capital. As noted in the summary, net interest income as a percentage of equity has remained in the 17% to 21% range throughout 2001 and 2002 to date as the beneficial effects of an improved asset mix and strong credit results has generally offset the diminishing benefit we are receiving over time from the decline in short-term interest rates during 2001.

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
Q2: 2001	\$38,453	\$(27,010)	\$11,443	7.18%	5.45%	1.73%	2.06%	20.8%
Q3: 2001	33,172	(21,555)	11,617	6.63%	4.83%	1.80%	2.24%	18.3%
Q4: 2001	31,277	(18,091)	13,186	5.41%	3.56%	1.85%	2.22%	17.4%
Q1: 2002	30,716	(15,602)	15,114	4.92%	2.82%	2.10%	2.36%	18.1%
Q2: 2002	36,252	(18,489)	17,763	4.71%	2.69%	2.02%	2.25%	19.1%
Six Months: 2001	\$80,090	\$(58,423)	\$21,667	7.45%	5.90%	1.55%	1.95%	19.8%
Six Months: 2002	66,968	(34,091)	32,877	4.80%	2.75%	2.05%	2.30%	18.6%

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 special-purpose bankruptcy-remote financing trusts and non-recourse debt securities are issued from these trusts. We account for these transactions as financings. Thus, the securitized assets (residential mortgage loans and securities) remain on our reported balance sheet and the debt securities the trusts issue remain on our balance sheet as liabilities (long-term debt).

If we had used a slightly different form of securitization and securitization accounting, we would account for these transactions as sales. With sales accounting, our reported balance sheet (both assets and liabilities) would be substantially smaller. As a result, any asset or liability-based 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 (sales accounting) 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. This presentation generally conforms 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.

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
Q2: 2001	\$23,286	\$(11,843)	\$11,443	8.35%	4.91%	3.44%	3.82%	20.8%
Q3: 2001	20,458	(8,841)	11,617	7.74%	4.15%	3.59%	4.11%	18.3%
Q4: 2001	19,328	(6,142)	13,186	6.98%	2.93%	4.05%	4.49%	17.4%
Q1: 2002	20,055	(4,941)	15,114	6.61%	2.12%	4.49%	4.72%	18.1%
Q2: 2002	23,358	(5,595)	17,763	7.39%	2.37%	5.02%	5.29%	19.1%
Six Months: 2001	\$47,085	\$(25,418)	\$21,667	8.66%	5.42%	3.24%	3.74%	19.8%
Six Months: 2002	43,413	(10,536)	32,877	6.85%	2.25%	4.60%	4.91%	18.6%

Interest Income After Credit Expenses

For the second quarter of 2002 compared to the second quarter of 2001, total interest income declined from \$38 million to \$36 million. For the first half of 2002 compared to the first half of 2001, total interest income declined from \$80 million to \$67 million. Interest income declined largely as a result of declines in mortgage rates on our adjustable rate mortgage assets. Our yield on these assets generally adjusts, with a lag, to changes in short-term interest rates (which fell in 2001). Due to asset growth, interest income did not decline as much it would have otherwise. For example, average earning assets in the second quarter of 2002 were 44% higher than in the second quarter of 2001.

Our portfolio profitability remained attractive despite falling interest income as our interest expenses generally declined in a similar fashion, in both cases due to falling short-term interest rates.

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
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%
Q2: 2002	3,080,165	37,267	(543)	(472)	36,252	4.71%
Six Months: 2001	\$2,150,599	\$83,192	\$ (2,754)	\$ (348)	\$80,090	7.45%
Six Months: 2002	2,790,972	71,244	(3,522)	(754)	66,968	4.80%

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 nearly doubled in the first half of 2002, increasing from \$1.5 billion at the beginning of 2002 to \$2.8 billion at June 30, 2002. We acquired \$1.6 billion residential mortgage loans during the first half of 2002. The majority of these acquisitions were adjustable rate loans. We

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plan to continue to expand our customer base and to acquire of high-quality jumbo residential mortgage loans at a rapid pace.

Table 5

Residential Mortgage Loans — Activity
(all dollars in thousands)

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Start of Period Balances	\$1,794,260	\$1,474,862	\$1,354,606	\$1,060,470	\$1,071,819
Acquisitions	1,146,621	417,276	207,170	391,328	76,314
Sales	(46,683)	0	0	0	0
Principal Payments	(89,582)	(95,924)	(82,676)	(96,172)	(86,511)
Amortization	(1,060)	(1,672)	(3,991)	(1,180)	(1,065)
Credit Provisions	(472)	(282)	(268)	(151)	(164)
Net Charge-Offs	0	0	29	311	12
Mark-To-Market (Balance Sheet)	0	0	0	0	0
Mark-To-Market (Income Statement)	472	0	(8)	0	65
End of Period Balances	\$2,803,556	\$1,794,260	\$1,474,862	\$1,354,606	\$1,060,470

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. Even though short-term interest rates have stabilized in 2002, the coupon rates on our variable rate loans continue to reset downwards due to the interest rates decline in 2001.

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
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%
Q2: 2002	2,195,570	11,489	(5,675)	19%	21,133	(1,060)	(472)	19,601	3.56%
Six Months: 2001	\$1,045,373	\$13,131	\$(4,973)	22%	\$37,863	\$ (1,550)	\$ (348)	\$35,965	6.83%
Six Months: 2002	1,870,181	10,316	(5,509)	19%	37,212	(2,732)	(754)	33,726	3.60%

Credit results remain excellent for our residential mortgage loan portfolio. At June 30, 2002, our residential mortgage loan credit reserve was \$6.0 million, equal to 0.21% of the current balance of this portfolio. Although we have reduced or eliminated on-going credit provision expenses associated with many of our seasoned loans, total credit provision expense increased in recent quarters due to the significant acquisitions of new residential mortgage loans.

Our residential loan portfolio delinquencies have been declining, from \$5.1 million at December 31, 2001 to \$3.3 million at June 30, 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 remain at low levels relative to the mortgage industry and stood at 0.12% of current loan balances at June 30, 2002. As noted in the summary, current credit trends have been favorable in part due to lack of seasoning of new loan acquisitions.

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Our current credit reserve has been established based on historical loss rates and the current weakened economy. We anticipate that delinquencies and losses will increase from current levels over time.

Table 7

Residential Mortgage Loans — Credit Results
(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
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
Q2: 2002	2,803,556	3,257	0.12%	0%	0	0.00%	5,953
Six Months: 2001	\$1,060,470	\$ 4,913	0.46%	13%	\$ (42)	0.01%	\$5,120
Six Months: 2002	2,803,556	3,257	0.12%	0%	0	0.00%	5,953

The characteristics of our loans continue to show the high-quality nature of our residential mortgage loan portfolio. At June 30, 2002, we owned 7,394 residential loans with a total value of \$2.8 billion. These were all "A" quality loans at origination. Substantially all these loans (96%) were adjustable rate loans and the rest (4%) were hybrid loans (fixed rate for 3 to 7 years, then adjustable). Our average loan size was \$379,166. Northern California loans were 13% of the total and Southern California loans were 12% of the total. Loans originated in 2002 were 47% of the total, loans originated in 2001 were 31% of the total, and loans originated in 2000 or earlier were 22% of the total. On average, our residential mortgage loans had 16 months of seasoning. Loans where the original loan balance exceeded 80% loan-to-value (LTV) made up 22% 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 believe the current effective LTV of our residential mortgage loans at June 30, 2002 was lower.

Table 8

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

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Principal Value (Face Value)	\$2,795,628	\$1,790,239	\$1,470,467	\$1,346,346	\$1,053,158
Internal Credit Reserves	(5,953)	(5,481)	(5,199)	(4,960)	(5,120)
Premium (Discount) to be Amortized	13,881	9,502	9,594	13,220	12,432
Retained Residential Loans	\$2,803,556	\$1,794,260	\$1,474,862	\$1,354,606	\$1,060,470
Number of loans	7,394	4,914	4,177	3,909	3,306
Average loan size	\$ 379	\$ 364	\$ 353	\$ 347	\$ 321
Adjustable %	96%	100%	100%	81%	73%
Hybrid %	4%	0%	0%	19%	27%
Fixed %	0%	0%	0%	0%	0%
Northern California	13%	12%	10%	10%	13%
Southern California	12%	11%	12%	12%	10%
Florida	13%	12%	11%	11%	9%
Georgia	9%	7%	8%	7%	4%
New York	6%	7%	8%	8%	9%
New Jersey	5%	5%	5%	5%	6%
Texas	3%	4%	4%	5%	5%
Other states	39%	42%	42%	42%	44%
Year 2002 origination	47%	17%	0%	0%	0%
Year 2001 origination	31%	42%	45%	34%	7%
Year 2000 origination	0%	0%	0%	0%	0%
Year 1999 origination	5%	9%	11%	12%	17%
Year 1998 origination or earlier	17%	32%	44%	54%	76%
% balance in loans > \$1mm per loan	15%	16%	15%	14%	11%

We intend to permanently fund all our mortgage loans within six months of purchase through the issuance of long-term debt through our special purpose subsidiaries, Sequoia Mortgage Funding Corporation and Sequoia Residential Funding Inc. (Sequoia). This type of financing is non-recourse to Redwood Trust. Our exposure to our \$2.2 billion of long-term financed loans is limited to our investment in Sequoia, which at June 30, 2002 was \$46.8 million or 2.1% of the Sequoia loan balances. Short-term funded residential mortgage loans at June 30, 2002 were \$0.6 billion. In the second quarter of 2002, we issued \$1.1 billion in long-term debt, completing Sequoia 6 and Sequoia 7. In July 2002, we completed Sequoia 8 and issued an additional \$0.6 billion of long-term debt. The proceeds of Sequoia 8 were used to pay down short-term debt. See Table 24 for detail on our long-term debt outstanding.

Residential Credit-Enhancement Securities

At June 30, 2002, we owned \$285 million of residential credit-enhancement securities, a net increase of \$35 million during the second quarter of 2002 and an increase of \$94 million since the beginning of the year. These securities have below-investment-grade credit ratings and represent subordinated interests in pools of high-quality jumbo residential mortgage loans. We continue to increase our capacity to evaluate and acquire

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these assets and to strengthen our relationships with the sellers and servicers of these assets. In the second half of 2002, we are continuing to acquire these securities, although so far in the second half we are doing so at a reduced pace due to higher prices and reduced supply.

Table 9**Residential Credit-Enhancement Securities — Activity**
(all dollars in thousands)

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Start of Period Balances	\$249,832	\$190,813	\$188,283	\$158,704	\$100,849
Acquisitions	25,849	59,157	17,132	27,172	61,195
Sales	(898)	(5,037)	(7,786)	0	(1,780)
Principal Payments	(15,801)	(4,270)	(3,857)	(1,895)	(1,952)
Amortization	1,767	366	(92)	86	161
Mark-To-Market (Balance Sheet)	21,795	8,758	(3,258)	4,216	223
Mark-To-Market (Income Statement)	2,215	45	391	0	8
End of Period Balances	\$284,759	\$249,832	\$190,813	\$188,283	\$158,704

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. Similarly, 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).

Our credit-enhancement interests can be called away from us under limited circumstances. This is usually beneficial for us, as we receive a payment for the full principal value of an asset that, in general, we have acquired at a discount to the principal value. Our mark-to-market income for GAAP for the second quarter of 2002 benefited from this type of call activity. We anticipate some additional assets may be called away in the next 12 months.

At June 30, 2002, we owned \$493 million principal (face) value of residential credit-enhancement securities at a cost basis of \$251 million. After mark-to-market adjustments, our net investment in these assets, as reported on our balance sheet, was \$285 million. Over the life of the underlying mortgage loans, we expect to receive principal payments from these securities of \$493 million less credit losses. We receive interest payments each month on the outstanding principal amount. Of the \$208 million difference between principal value and reported value, \$206 million was designated as an internal credit reserve (reflecting our estimate of future credit losses over the life of the underlying mortgages), \$36 million was designated as

purchase discount to be accreted into income over time, and there was \$34 million in cumulative positive balance sheet market valuation adjustments.

Table 10

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

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Total principal value (face value)	\$ 492,642	\$ 460,035	\$ 353,435	\$ 323,870	\$266,004
Internal credit reserves	(206,343)	(194,556)	(140,411)	(112,133)	(78,170)
Discount to be amortized	(35,745)	(28,058)	(25,863)	(30,365)	(31,824)
Net investment	250,554	237,421	187,161	181,372	156,010
Market valuation adjustments	34,205	12,411	3,652	6,911	2,694
Net book value	\$ 284,759	\$ 249,832	\$ 190,813	\$ 188,283	\$158,704
First loss position, principal value	\$ 181,179	\$ 173,990	\$ 129,019	\$ 105,830	\$ 76,386
Second loss position, principal value	139,290	127,930	96,567	84,876	67,700
Third loss position, principal value	172,173	158,115	127,849	133,164	121,918
Total principal value	\$ 492,642	\$ 460,035	\$ 353,435	\$ 323,870	\$266,004
First loss position, reported value	\$ 46,979	\$ 42,760	\$ 29,648	\$ 25,886	\$ 18,956
Second loss position, reported value	90,878	79,969	60,074	53,925	43,733
Third loss position, reported value	146,902	127,103	101,091	108,472	96,015
Total reported value	\$ 284,759	\$ 249,832	\$ 190,813	\$ 188,283	\$158,704

Total interest income from our residential credit-enhancement securities increased to \$9.0 million in the second quarter, from \$6.7 million in the first quarter of 2002 and \$3.4 million in the second quarter of 2001. An increase in our net investment in these securities was the principal reason for the increase in interest income from this portfolio. For the same reason, our income during the first six months of 2002 of \$15.7 million was a significant increase from the \$6.0 million we earned during the first six months of 2001 from this portfolio.

Our credit-enhancement portfolio yield was 15.12% during the second quarter of 2002, an increase from the 13.29% yield earned in the first quarter of 2002, and an increase from the 11.97% yield earned in the second quarter of 2001. Over the past several quarters, we have increased the yields recognized for our assets that are performing well (lower delinquencies, lower credit losses, faster prepayments) and that are expected to continue to perform well relative to our initial assumptions. In addition, yields in this portfolio have been increasing due to the acquisition of an increased proportion of first and second loss interests which generally have higher yields than third loss interests due to their higher risk levels. For similar reasons, the average yield for this portfolio in the first six months of 2002 was 14.27%, an increase from the 12.11% this portfolio yielded during the first six months of 2001.

The yield we estimate and recognize under the effective yield method for each of our assets is subject to change over time as we constantly review our assumptions and we have increased performance data for each specific asset as the asset seasons. 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 impairment adjustments are applied 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
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%
Q2: 2002	467,108	(198,564)	(30,262)	238,282	7,239	1,767	9,006	15.12%
Six Months: 2001	\$160,107	\$ (40,178)	\$(20,100)	\$ 99,829	\$ 5,758	\$ 287	\$ 6,045	12.11%
Six Months: 2002	428,666	(181,872)	(26,781)	220,013	13,568	2,133	15,701	14.27%

Credit losses for the \$66 billion of residential loans that we credit enhanced through our ownership of residential credit-enhancement securities at June 30, 2002 totaled \$0.1 million in the first quarter of 2002. The annualized rate of credit loss was less than 1 basis point (0.01%) of the underlying loans.

Delinquencies (over 90 days, foreclosure, bankruptcy, and REO) in our credit-enhancement loans have remained relatively steady at low levels. They were 0.23% of current balances at the end of the second quarter of 2002, 0.20% at the end of the first quarter of 2002, and 0.24% at the beginning of the year. We expect delinquencies and losses 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 credit-enhanced loan amounts through the acquisition of credit-enhancement securities on performing loan pools (as occurred in the first half of 2002), delinquencies as a percent of the underlying pool balances may decline due to a lack of seasoning of acquired loans.

Table 12

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

	Underlying Mortgage Loans	Delinquencies		Redwood's Share of Credit (Losses) Recoveries	Losses To External Credit Enhancement	Total Credit Losses	Total Credit Losses as % of Loans (Annualized)
		\$	%				
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%
Q2: 2002	66,061,159	149,960	0.23%	74	(189)	(115)	0.01%
Six Months: 2001	\$38,278,631	\$ 98,287	0.26%	\$ (251)	\$ (1,374)	\$(1,625)	0.01%
Six Months: 2002	66,061,159	149,960	0.23%	240	(807)	(567)	0.01%

At June 30, 2002, we had \$65 million of external credit enhancements and \$206 million of internal credit reserves for this portfolio. External credit reserves serve to protect us from credit losses on a specific asset basis

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and represent the principal value of interests that are junior to us and are owned by others. Total reserves of \$271 million represented 41 basis points (0.41%) of our credit-enhancement portfolio of \$66 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)

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Internal Credit Reserves	\$206,343	\$194,556	\$140,411	\$112,133	\$ 78,170
External Credit Enhancement	65,102	79,924	90,224	94,745	91,004
Total Credit Protection	\$271,445	\$274,480	\$230,635	\$206,878	\$169,174
As % of Total Portfolio	0.41%	0.42%	0.45%	0.41%	0.44%

Based on the most recent loan level detail available for each pool in which we own an interest, the following provides a summary of the characteristics of the loans in our credit-enhancement portfolio. At June 30, 2002, we credit enhanced 165,515 loans in this portfolio. Of the \$66 billion loan balances, 66% were fixed-rate loans, 15% 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 \$399,125. We credit-enhanced 2,132 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 \$3.1 billion. Loans over \$1 million were 1% of the total number of loans and 5% of the total balance of loans that we credit-enhanced at quarter-end.

The characteristics of the loans that we credit enhance continue to illustrate the high-quality nature of the loans. The average FICO score of borrowers on residential mortgage loans underlying our residential credit-enhancement securities (for those loans where a FICO score was obtained) was 728. Borrowers with FICO scores over 720 comprised 60% of this 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 that may serve to mitigate the apparent risk of the lower FICO score.

On average, our credit-enhanced loans had 25 months of seasoning at June 30, 2002. 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 8% 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 71%. Given housing appreciation and loan amortization, we believe the average current effective LTV for these loans at June 30, 2002 was lower.

Table 14

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

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Credit-enhancement securities	\$66,061,159	\$64,826,605	\$51,720,856	\$49,977,641	\$38,278,631
Number of credit-enhanced loans	165,515	162,502	133,634	132,555	105,721
Average loan size	\$ 399	\$ 398	\$ 387	\$ 377	\$ 362
Adjustable %	19%	19%	15%	11%	19%
Hybrid %	15%	14%	17%	19%	20%
Fixed %	66%	67%	68%	70%	61%
Northern California	25%	25%	27%	25%	26%
Southern California	24%	25%	26%	26%	28%
New York	5%	5%	5%	5%	5%
Texas	4%	4%	4%	4%	3%
Virginia	3%	3%	3%	3%	3%
New Jersey	3%	3%	3%	3%	3%
Other states	36%	35%	32%	34%	32%
Year 2002 origination	1%	1%	0%	0%	0%
Year 2001 origination	54%	55%	43%	32%	21%
Year 2000 origination	7%	8%	10%	14%	14%
Year 1999 origination	18%	17%	22%	31%	36%
Year 1998 or earlier origination	20%	19%	25%	23%	29%
% balance in loans > \$1mm per loan	5%	4%	4%	3%	4%

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 June 30, 2002 the average loan balance was \$425,441, the average FICO score was 730, and the average LTV at origination was 68%. On average, these Northern California loans had 23 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 quarter end, 677 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 \$955 million. They represented 2% of the total number of Northern California loans and 6% of the total balance of Northern California loans. Delinquencies in our Northern California residential credit-enhancement portfolio at June 30, 2002 were 0.13% of current loan balances.

For the loans that we credit enhanced where the home was located in Southern California (24% of the total portfolio), at June 30, 2002 the average loan balance was \$412,102, the average FICO score was 725, and the average LTV at origination was 70%. On average, these Southern California loans had 32 months of seasoning, with 1% originated in year 2002, 44% in year 2001, 4% in year 2000, and 51% in years 1999 or earlier. At quarter end, 676 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 \$979 million. They represented 2% of the total number of Southern California loans and 6% of the total balance of Southern California loans. Delinquencies

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in our Southern California residential credit-enhancement portfolio at June 30, 2002 were 0.32% 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
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%
Q2: 2002	68,864,715	212,296	65,102	277,398	0.40%
Six Months: 2001	\$39,339,101	\$ 83,290	\$ 91,004	\$174,294	0.44%
Six Months: 2002	68,864,715	212,296	65,102	277,398	0.40%

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)
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%
Q2: 2002	153,217	0.22%	74	(189)	(115)	0.01%
Six Months: 2001	\$ 103,200	0.26%	\$ (293)	\$ (1,374)	\$(1,667)	0.01%
Six Months: 2002	153,217	0.22%	240	(807)	(567)	0.01%

Commercial Mortgage Loans

Our commercial real estate loan portfolio has remained in the \$49 million to \$51 million range this year with minor levels of activity. We plan to continue to acquire more commercial loans and commercial loan participations in the future.

Table 17

Commercial Mortgage Loans — Activity
(all dollars in thousands)

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Start of Period Balances	\$49,380	\$51,084	\$ 64,362	\$67,043	\$70,077
Acquisitions	470	140	210	0	1,500
Sales	0	0	0	(2,645)	(3,573)
Principal Payments	(53)	(1,873)	(13,403)	(44)	(897)
Amortization	0	28	29	15	104
Mark-To-Market (Balance Sheet)	0	0	0	0	0
Mark-To-Market (Income Statement)	1	1	(114)	(7)	(168)
End of Period Balances	\$49,798	\$49,380	\$ 51,084	\$64,362	\$67,043

The yield on our commercial mortgage loans decreased in the second quarter of 2002 from both the first quarter of 2002 and the second quarter of 2001 due to a reduction in fees recognized at the time of a loan payoff. For similar reasons, the yield during the first half of 2002 was lower than the yield during the first half of 2001. Early payoffs generally result 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 during 2001 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
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%
Q2: 2002	50,036	(667)	1,233	0	0	1,233	9.99%
Six Months: 2001	\$72,043	\$(1,042)	\$3,714	\$ 179	\$ 0	\$3,893	11.00%
Six Months: 2002	50,452	(684)	2,480	27	0	2,507	10.07%

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

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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)

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Commercial Mortgage Loans	\$49,978	\$49,380	\$51,084	\$64,362	\$67,043
Number of Loans	8	7	8	14	16
Average Loan Size	\$ 6,247	\$ 7,054	\$ 6,386	\$ 4,597	\$ 4,190
Serious Delinquency \$	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Realized Credit losses	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
California %	61%	61%	59%	67%	68%

Our goal is to secure long-term non-recourse debt for our commercial mortgage loans. In the first half of 2002, we issued \$8 million of long-term debt collateralized debt for our commercial real estate loans. At June 30, 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. In the second quarter of 2002, we acquired a subordinate participation in a commercial mortgage loan. Our loan participations and our remaining commercial mortgage loans were financed with either equity or a combination of equity and medium-term credit facilities.

Securities Portfolio

Our securities portfolio consists of all the securities that we own, with the exception of cash-equivalent securities and the residential credit-enhancement securities that are broken out and discussed separately above.

At June 30, 2002, our securities portfolio consisted primarily of AAA and AA rated residential mortgage securities. We are currently accumulating lower-rated (primarily investment-grade, with A and BBB ratings) and more diverse (primarily real estate related) securities with the anticipation of funding these assets with long-term non-recourse debt in a Collateralized Bond Obligation transaction. We also intend to acquire below-investment-grade commercial mortgage credit-enhancement securities from time to time.

During the first half of 2002, our securities portfolio decreased from \$683 million to \$512 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 portfolio and/or to fund our securities with long-term debt. In the second quarter of 2002, we completed a \$81 million long-term debt funding for securities (SMFC 2002-A). Securities that we owned that were not long-term debt funded and that were not part of

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accumulation program for future long-term debt issuance totaled \$683 million at December 31, 2001 and \$341 million at June 30, 2002.

Table 20

Securities Portfolio — Activity
(all dollars in thousands)

	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
Start of Period Balances	\$609,432	\$683,482	\$608,793	\$ 739,187	\$1,000,612
Acquisitions	23,026	76,701	147,251	47,323	16,051
Sales	(56,802)	(89,395)	(15,260)	(106,297)	(162,753)
Principal Payments	(65,617)	(60,040)	(53,400)	(71,692)	(113,165)
Premium Amortization	(1,249)	(1,701)	(799)	(898)	(1,086)
Mark-To-Market (Balance Sheet)	3,017	(444)	(2,034)	1,087	(94)
Mark-To-Market (Income Statement)	683	829	(1,069)	83	(378)
End of Period Balances	\$512,490	\$609,432	\$683,482	\$ 608,793	\$ 739,187

Total interest income from our securities portfolio was \$6.2 million in the second quarter, a decrease from \$8.5 million in the first quarter of 2002 and a decrease from \$16.6 million in the second quarter of 2001. This decrease was the result of lower average balances and lower yields. For similar reasons, total interest income during the first six months of 2002 was \$14.7 million, a decrease from the \$33.6 million during the first six months of 2001.

Yields in this portfolio continued to fall as most of these assets are variable rate assets and the coupons are resetting downwards as a result of falling short-term interest rates during 2001. The yield in the second quarter of 2002 was 4.70%, a decrease from 5.03% in the first quarter of 2002 and 7.16% in the second quarter of 2001. During the first six months of 2002, the yield was 4.89%, a decrease from 7.43% in the first half of 2001. Actual and anticipated mortgage prepayment rates remained relatively high, further depressing yields due to faster amortization of purchase premiums.

Table 21

Securities Portfolio — Interest Income 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
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%
Q2: 2002	520,844	8,999	28%	7,471	(1,249)	6,222	4.70%
Six Months: 2001	\$892,651	\$12,109	25%	\$35,282	\$ (1,672)	\$33,610	7.43%
Six Months: 2002	593,304	9,557	30%	17,686	(2,950)	14,736	4.89%

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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	Jun. 2002	Mar. 2002	Dec. 2001	Sep. 2001	Jun. 2001
FNMA & FHLMC — Adjustable	“AAA”	\$236,084	\$285,174	\$353,523	\$389,400	\$434,732
FNMA & FHLMC — Hybrid	“AAA”	0	0	20,223	0	2,828
Jumbo Prime — Adjustable	AAA or AA	134,871	157,279	144,813	138,261	243,078
Jumbo Prime — Hybrid	AAA or AA	99,540	133,456	137,926	43,775	0
Jumbo Prime — Fixed	AAA or AA	10,196	4,961	5,018	15,732	24,815
Subprime — Floaters	AAA or AA	20,935	20,935	14,600	14,600	14,600
Subprime — Fixed	AAA to BBB	0	0	600	1,050	13,026
Interest-Only — Residential	AAA	0	0	13	53	60
Interest-Only — Commercial	AAA	6,508	4,768	4,874	5,008	5,082
CBO Equity — Mixed Real Estate	B or NR	4,356	2,859	1,892	914	966
Total Securities Portfolio		\$512,490	\$609,432	\$683,482	\$608,793	\$739,187

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.

Interest Expense

Short-term interest rates stabilized in the first half of 2002 after falling for most of 2001. However, our cost of borrowed funds continued to fall over these past six months as the interest expense on a portion of these funds adjusts to market conditions with a lag. Our cost of funds was 2.69% during the second quarter of 2002, a decrease from 2.82% in the first quarter of 2002 and from 5.45% in the second quarter of 2001. Our cost of borrowed funds during the first six months of 2002 was 2.75%, a decrease (for similar reasons) from 5.90% in the first six months of 2001.

Our average debt levels continued to rise as we acquired loans and issued long-term debt to fund the acquisitions. The average borrowings were \$2.8 billion during the second quarter of 2002, an increase from \$2.2 billion in the first quarter and \$2.0 billion in the second quarter of 2001. Our average debt balance in the first six months of 2002 was an increase from the \$2.0 billion we averaged in the first half of 2001.

In the second quarter of 2002, our increased amount of borrowed funds resulted in an increase in total interest expense from the previous quarter, in spite of the decrease in our cost of funds. Total interest expense was \$18.5 million in the second quarter of 2002, as compared to \$15.6 million in the first quarter of 2002. In comparison to a year ago, however, our interest expense declined due to rapidly falling cost of funds despite increased borrowings. For the second quarter of 2001 total interest expense was \$27.0 million.

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Due to the decrease in short-term rates, and thus our cost of funds, our total interest expense of \$34.1 million in the first half of 2002 was significantly lower than the \$58.4 million interest expense in the first six months 2001.

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
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%
Q2: 2002	1,806,884	12,894	2.85%	945,331	5,595	2.37%	18,489	2.69%
Six Months: 2001	\$1,045,261	\$33,005	6.32%	\$937,678	\$25,418	5.42%	\$58,423	5.90%
Six Months: 2002	1,545,148	23,555	3.05%	938,416	10,536	2.25%	34,091	2.75%

The table below lists our long-term debt issuances through June 30, 2002.

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 Jun. 30, 2002	Interest Rate At Jun. 30, 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	203,341	3.77%
Sequoia 2 A2	AAA	11/6/97	156,600	1m LIBOR	3/30/29	2003	53,739	2.18%
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	0	n/a
Sequoia 3 A4	AAA	6/26/98	121,923	Fixed to 12/02	5/31/28	2002	97,354	6.25%
Sequoia 3 M1	AA/AAA	6/26/98	16,127	Fixed to 12/02	5/31/28	2002	16,127	6.77%
Sequoia 3 M2	A/AA	6/26/98	7,741	Fixed to 12/02	5/31/28	2002	7,741	6.77%
Sequoia 3 M3	BBB/A	6/26/98	4,838	Fixed to 12/02	5/31/28	2002	4,838	6.77%
Sequoia 1A A1	AAA	5/4/99	157,266	1m LIBOR	2/15/28	Called	0	n/a
Sequoia 4 A	AAA	3/21/00	377,119	1m LIBOR	8/31/24	2005	225,311	2.20%
Commercial 1	N/A	3/30/01	9,010	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	2007	471,281	2.19%
Sequoia 5 B1	AA	10/29/01	5,918	1m LIBOR	10/29/26	2007	5,918	2.64%
Sequoia 5 B2	A	10/29/01	5,146	1m LIBOR	10/29/26	2007	5,146	2.64%
Sequoia 5 B3	BBB	10/29/01	2,316	1m LIBOR	10/29/26	2007	2,316	2.64%
Commercial 3	N/A	3/1/02	8,318	1m LIBOR	7/1/03	N/A	8,307	8.63%
Sequoia 6A	AAA	4/26/02	496,378	1m LIBOR	4/26/27	2008	486,200	2.16%
Sequoia 6B1	AA	4/26/02	5,915	1m LIBOR	4/26/27	2008	5,915	2.54%
SMFC 2002-A A1	AAA	4/30/02	64,761	1m LIBOR	4/30/30	2008	61,215	2.44%
SMFC 2002-A A2	AAA	4/30/02	15,861	1m LIBOR	8/30/29	2008	15,442	2.59%
Sequoia 7A	AAA	5/29/02	554,686	1m LIBOR	5/29/32	2008	551,171	2.18%
Sequoia 7B1	AA	5/29/02	8,080	1m LIBOR	5/29/32	2008	8,080	2.59%
Total Long-Term Debt			\$4,134,556				\$2,246,772	2.62%

In July 2002, we issued \$0.6 billion of long-term debt through Sequoia 8. We plan to issue more long-term debt throughout the second half of the year.

Operating Expenses

Operating expenses as a percentage of equity is, in our opinion, the best measure of operating cost efficiency for our company. Although this measure varies from quarter to quarter — due to factors such as equity offerings and variable compensation expense accruals tied to earnings and dividends — the general trend has been towards greater productivity. Operating expenses as a percentage of equity improved from 6.1% in the second quarter of 2001 to 4.9% in the second quarter of 2002. Over the twelve months ending June 30, 2002, our equity base (a good measure of the scope of our business) increased by 73% while our year-over-year second quarter operating expenses increased by 34%.

If we continue to increase the scale of our business, we would generally 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.

Table 25

**Operating Expenses
(all dollars in thousands)**

	Operating Expenses	Fixed Operating Expenses	Variable (Performance Based) Operating Expenses	Operating Expenses/Average Equity	Efficiency Ratio: Operating Expenses/Net Interest Income
Q2: 2001	\$ 3,378	\$ 1,754	\$ 1,624	6.1%	30%
Q3: 2001	2,748	1,281	1,467	4.3%	24%
Q4: 2001	2,730	1,563	1,167	3.6%	21%
Q1: 2002	3,546	1,758	1,788	4.3%	23%
Q2: 2002	4,536	2,081	2,455	4.9%	26%
Six Months: 2001	\$ 6,358	\$ 3,316	\$ 3,042	5.8%	29%
Six Months: 2002	8,082	3,839	4,243	4.6%	25%

Stock Option Costs

We currently recognize the cost of stock option issuance in our GAAP financial statements in two ways. First, in accordance with GAAP, we recognize in our per-share calculations the potential dilutive effect of all of our outstanding options that are in-the-money (those that have an option strike price less than the current Redwood share price). Our GAAP earnings per share, which is calculated on a diluted shares basis, was \$0.88 in the second quarter of 2002. Without this calculation of potential dilution, reported GAAP earnings (per basic share) would have been \$0.91 per share. At June 30, 2002, the difference between our basic shares outstanding and diluted shares outstanding (incorporating the potential dilutive effect of options) was 518,790 shares, or 3.4% of our basic shares outstanding.

Second, we include in GAAP income calculation (as part of mark-to-market adjustments) stock option expenses associated with a portion of our stock options that require variable accounting treatment under GAAP. This GAAP income expense represents the change in the in-the-money amount (stock price less strike price, times number of options outstanding) of a portion of our outstanding stock options. This is not a cash expense. In periods of stock price appreciation (like the first half of 2002), this expense can be significant; it totaled \$1.3 million, or \$0.09 per diluted share, for the first six months of 2002. During periods of stock price decline, this accounting treatment may actually provide a net gain in mark-to-market.

We have not adopted FAS 123 as a method of accounting for stock options and related items. As disclosed in our Annual Report on Form 10-K for the year ended December 31, 2001, to the effect last year of

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adoption of this method of accounting would have been less than 2% of our GAAP net income. In the future, any FAS 123 expense will depend on option expense valuation methods and future option granting practices.

Other Income (Expense)

In the first half of 2002, other income and expense consisted primarily 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 half of 2002, income statement mark-to-market adjustments totaled a positive \$2.9 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 \$36.0 million in the first half of 2002. These increases in market values were due to falling interest rates, increased competition and demand for mortgage assets in the market, favorable prepayment and credit performance, and other factors.

Shareholder Wealth

In the nearly 8 years since the commencement of Redwood's operations, cumulative shareholder wealth has grown at a compound rate of 19% 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 assume that dividends were reinvested through the purchase of additional shares at the prevailing book value per share. With this assumption, the shareholder wealth we 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 \$25.05 per share at June 30, 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 at prices 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 \$11.245 per share, and reinvestment earnings on those dividends were \$9.17 per share. Thus, cumulatively, shareholder wealth has increased from \$11.67 per share to \$45.46 per

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share during this nearly 8-year period. A company that earned a 19% 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	\$ 0.000	\$ 0.000	\$ 0.00	\$ 11.67
Dec. 1994	10.82	0.250	0.250	0.00	11.07
Dec. 1995	12.38	0.960	1.210	0.09	13.68
Dec. 1996	16.50	1.670	2.880	1.07	20.45
Dec. 1997	21.55	2.150	5.030	3.07	29.65
Dec. 1998	20.27	0.280	5.310	2.67	28.25
Dec. 1999	20.88	0.400	5.710	3.07	29.66
Dec. 2000	21.47	1.610	7.320	4.11	32.90
Dec. 2001	22.21	2.550	9.870	6.03	38.11
Jun. 2002	25.05	1.375	11.245	9.17	45.46

Taxable Income and Dividends

To date, we have generally distributed 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. However, to maintain our REIT status, we need only distribute 90% of our REIT taxable income. We may elect to retain (and pay taxes on) up to 10% of our REIT taxable income in the future.

Our REIT taxable income may differ materially from our core earnings or reported GAAP income. Income calculation methods differ. Also, we conduct a portion of our real estate finance business in taxable subsidiaries; taxable income earned in these subsidiaries is part of GAAP and core earnings but is not part of our REIT taxable income and is not subject to minimum dividend distribution requirements. We may elect to transfer a larger portion of our business to our taxable subsidiaries, which would likely have the effect of raising our tax liabilities (after the net tax operating losses in these subsidiaries were utilized) and reducing our minimum dividend distribution requirements, but increasing retained earnings over time. This may have the effect of reducing our special dividend payments in the future; our goal in taking any such actions would be to increase the sustainability (and future growth rate) of our current regular dividend.

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 June 30, 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, unless we encounter stressful conditions. In years when our minimum dividend distribution requirements under the REIT rules exceed what we believe to be our sustainable dividend rate, the Board may declare one or more special quarterly cash dividends.

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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 for tax purposes.

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 analyses received from external sources, internal models, and our own judgment and experience.

One of the many significant assumptions 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

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assessment of various factors affecting our assets, including current and projected economic conditions, characteristics of the underlying loans, delinquency status, and external credit protection. We use a variety of internal and external credit risk, cash flow modeling, and portfolio analytical tools to assist us in our assessment. 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, credit 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 half of 2002, cash flow from operations was \$27 million, consisting of earnings of \$25 million plus non-cash depreciation, amortization, compensation, and mark-to-market adjustments of \$2 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 \$30 million. In addition, we issued \$73 million in common stock during the quarter through two common stock offerings and our direct stock purchase and dividend reinvestment plan. We used the available cash from these sources to fund our common stock dividend of \$17 million and to increase our net investment in our real estate activities by \$86 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
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
Q2: 2002	13,802	(390)	13,412	3,561	16,973	(9,067)	26,563	34,469
Six Months: 2001	\$13,143	\$4,349	\$17,492	\$ 3,421	\$20,913	\$ (8,324)	\$ 1,534	\$14,123
Six Months: 2002	25,021	2,390	27,411	2,436	29,847	(16,664)	72,725	85,908

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. These committed facilities are generally for a term of up to one year, although certain assets maybe funded for periods up to three years. These committed facilities have restrictions on pledged asset types and debt covenant tests; we continue to meet these requirements.

At June 30, 2002, we had over a dozen uncommitted facilities for short-term collateralized debt, with credit approval in excess of \$4 billion of borrowings. We have had no difficulty securing short-term borrowings on favorable terms. Outstanding borrowings under these agreements were \$361 million at June 30, 2002, a decrease from \$568 million at year-end 2001, due to a reduction in our securities portfolio.

At June 30, 2002, we also had three short-term facilities totaling \$1.4 billion available to fund our residential mortgage loans we acquire in anticipation of a securitization transaction. The amount we have outstanding at any quarter end is a function of the pace of our acquisitions relative to the timing of our securitizations. We had \$592 million outstanding short-term borrowings collateralized by residential mortgages at June 30, 2002, an increase from \$146 million at December 31, 2001. We completed a securitization in July 2002 and used the proceeds from the long-term debt issued in the securitization to pay down the bulk of these short-term borrowings. The amount of short-term borrowings collateralized with residential mortgage loans that we have will continue to fluctuate from month to month as our acquisition and securitization program continues.

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 June 30, 2002. In addition to these committed facilities, we may also finance securities with lower than investment grade ratings through non-committed borrowing arrangements. Outstanding borrowings under all these agreements were \$52 million at June 30, 2002, a decrease from \$83 million at December 31, 2001. For our commercial loans, we have been replacing short-term debt funding with long-term debt funding; as we continue to do this, we may reduce our short-term debt facilities for commercial loans in the future. To fund our residential credit-enhancement securities acquisition program, we are seeking efficient forms of long-term debt issuance to replace short-term funding. We may issue long-term debt for this purpose through our CBO program or through other means.

At this time, we see no material negative trends that we believe would affect our access to long-term borrowings, 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. Our covenants generally relate to our tangible net worth, liquidity reserves, and leverage requirements. We have not, nor do we currently anticipate, any problems in meeting these covenants. However, many factors, including ones external to us, may affect our liquidity in the future.

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 June 30, 2002, we had \$38 million of unrestricted cash and highly liquid (unpledged) assets available to meet potential liquidity needs. Total available liquidity equaled 4% 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. The decline in this ratio over

the past six months is primarily the result of the increase in short-term borrowings funding our residential mortgage loans prior to the securitization in July 2002.

Long-Term Debt

The \$2.2 billion of long-term debt on our June 30, 2002 consolidated balance sheet was non-recourse debt. Substantially all this debt was issued through our special purpose financing subsidiaries (our Sequoia program) and was collateralized by residential mortgage loans. The holders of our long-term debt can look for repayment from the cash flows from the mortgages specifically collateralizing the debt; the debt is non-recourse to Redwood. 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 July 2002, we issued \$0.6 billion of long-term debt through Sequoia 8, and we plan to issue more long-term debt throughout the second half of 2002.

Of the remaining long-term debt, \$26 million was backed by commercial loans and was created through the sale of senior loan participations. 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.

The remaining \$76 million of long-term debt was issued through a re-securitization of a portion of our AAA and AA rated residential mortgage securities portfolio. We completed this resecuritization in April 2002 and used the proceeds to reduce our short-term repo debt funding of these securities.

We hope to pursue other opportunities to replace our short-term debt funding our assets with long-term, non-recourse debt over time. We are currently accumulating a diverse portfolio of real estate and asset-backed securities; our goal is to issue long-term debt in the form of Collateralized Bond Obligation securities to fund these new acquisitions as well as portions of our existing securities and residential credit-enhancement portfolios.

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 \$418 million in the first half of 2002 as a result of \$33 million in asset appreciation, \$4 million in retention of cash flow, equity offerings totaling \$55 million, and \$18 million in stock issuance through our direct stock purchase and dividend reinvestment program. 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 June 30, 2002, our aggregate equity capital guidelines were: 74% of residential credit-enhancement portfolio interests; 100% of net retained interests in residential loan portfolio after long-term debt issuance (Sequoia equity); 8% of short-term debt funded residential mortgage loans; 12% of securities portfolio; and 30% of commercial mortgage loan portfolio.

Our total risk-adjusted capital guideline amount for assets on our balance sheet was \$380 million at June 30, 2002. Capital required for outstanding commitments at June 30, 2002 for asset purchases settling in the third quarter of 2002 was \$4 million. Thus, at June 30, 2002, our total capital committed was \$384 million, our total capital available was \$418 million, and our excess capital to support growth in the second half of 2002 was \$34 million.

Balance Sheet Leverage

As reported on our balance sheet of June 30, 2002, our equity-to-reported-assets ratio was 11% and our reported debt-to-equity ratio was 7.8 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 — 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 June 30, 2002 were \$3.7 billion; of these, \$2.3 billion were pledged to non-recourse debt and \$1.4 billion were “at-risk”. Total reported liabilities at June 30, 2002 were \$3.3 billion; non-recourse debt was \$2.2 billion and recourse debt was \$1.0 billion. On a recourse-only basis, our ratio of equity-to-at-risk-assets was 31% and our ratio of recourse-debt-to-equity was 2.2 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
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
Q2: 2002	1,355,971	938,041	417,930	31%	2.2	11%	7.8

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, reinvestment risk, 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 portion of our securities portfolio is also exposed to credit risk; the remainder 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 under GAAP of a credit reserve for loans or a future credit loss assumption (in essence, a form of credit reserve) for other assets to calculate long-term yields 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 and effective yield recognition methods 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. Many 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. For securities portfolio assets where credit risk exists, we establish a reserve, as is appropriate given the credit trends and market outlook for that asset.

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 June 30, 2002, we had \$1.0 billion of short-term debt collateralized by assets. Of this debt, \$356 million was collateralized by assets in our securities portfolio (primarily AAA and AA rated mortgage backed securities), \$57 million by residential credit-enhancement securities, and \$592 million by high-quality residential mortgage loans under accumulation for future securitizations. 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 that may help preserve access to liquidity and help mitigate the effect of any disruptions to our operations in the event of certain disasters.

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The table below presents our contractual obligations as of June 30, 2002. The debt appears on our balance sheet. The operating leases are commitments that 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 June 30, 2002
(all dollars in thousands)

	Total	Stated Maturities	Comments
Short-term debt	\$1,005,003	2002	Weighted average maturity is 124 days
Long-term debt, residential	\$2,216,025	2024-2032	Non-recourse debt amortizes as residential collateral pays down
Long-term debt, commercial	\$ 25,575	2002-2003	Non-recourse debt amortizes as commercial collateral pays down
Asset purchase commitments	\$ 104,303	2002	Most acquisitions were completed in July 2002
Operating leases	\$ 2,280	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 June 30, 2002, the interest rate characteristics of our debt, as adjusted for outstanding interest rate agreements (see discussion below), closely matched the interest rate characteristics of our assets that were funded with debt. We had \$3.2 billion of adjustable-rate assets funded with \$3.1 billion of adjustable-rate debt. We had \$0.1 billion of fixed/hybrid debt funding a portion of our fixed/hybrid assets. The remainder of our assets (mostly hybrid and fixed-rate assets, but also a portion of our variable-rate assets) were funded with our \$0.4 billion of equity.

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 several 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 our short-term interest rate mismatch. As short-term interest rates have stabilized in 2002, our earnings benefit from this source has been diminishing and, assuming rates remain stable, will continue to diminish in the second half of 2002.

Recently, we have generally been able to achieve our desired asset/liability mix on-balance sheet without significant use of derivatives. As the table below shows, our variable-rate assets are generally funded with variable-rate debt and our unhedged fixed-rate assets are generally funded with equity. We believe that our use of interest rate derivative agreements as part of our asset/liability strategy is likely to increase in the future as we expand our product lines, develop our CBO program, and acquire more fixed-rate and hybrid loans and securities that will need to be hedged prior to securitization. As of June 30, 2002, we had \$129 million of notional amounts of interest rate agreements. In combination with a like amount of variable rate debt, these

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agreements effectively create fixed rate debt. These amounts are shown as hybrid and fixed rate debt in the table below.

During 2002, we have reduced the amount of net fixed rate assets we own (fixed rate or hybrid assets that are not hedged or funded with fixed rate debt) relative to the size of our equity base. Net fixed assets equaled 100% of equity at December 31, 2001 and 77% of equity at June 30, 2002. This reduction in net fixed rate assets diminishes current period income, but also should allow — relative to the net fixed rate exposure we had at year-end — for increased earnings and more stable book value in a rising interest rate environment.

Table 30

Asset/Liability Matching as of June 30, 2002
(all dollars in thousands)

Asset Type	Asset Amount	One-Month LIBOR Liabilities	One-Year Treasury Liabilities	Fixed/Hybrid Liabilities	Non-Interest Bearing Liabilities	Equity	Total Liabilities And Equity
Cash (unrestricted)	\$ 13,155	\$ 13,155	\$ 0	\$ 0	\$ 0	\$ 0	\$ 13,155
One Month LIBOR	795,569	795,569	0	0	0	0	795,569
Six Month LIBOR	1,972,186	1,972,186	0	0	0	0	1,972,186
COFI/ Other ARM	36,876	36,876	0	0	0	0	36,876
One Year Treasury	351,126	96,475	203,342	0	0	51,309	351,126
Fixed/Hybrid<1 Yr*	46,206	0	0	0	0	46,206	46,206
Hybrid	294,718	0	0	129,000	0	165,718	294,718
Fixed	153,922	0	0	0	0	153,922	153,922
Non-Earning Assets	26,024	0	0	0	25,249	775	26,024
Total	<u>\$3,689,782</u>	<u>\$2,914,261</u>	<u>\$203,342</u>	<u>\$129,000</u>	<u>\$25,249</u>	<u>\$417,930</u>	<u>\$3,689,782</u>

* 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 is preferred.

Prepayments affect short-term earnings primarily through amortization of purchase premium and discount. Although we have roughly equal amounts of premium and discount, amortization income from discount assets will not necessarily offset amortization expenses from premium assets. Variations in current and projected prepayment rates for individual assets, differing accounting methods for different assets, and changes in short-term interest rates (as they effect projected coupons on adjustable rate mortgages, and thus

change effective yield calculations) may cause net premium amortization expense or income to vary substantially from quarter to quarter.

Table 31

Unamortized Premium and Discount Balances*
(all dollars in thousands)

	Gross Premium	Gross Discount	Net Premium/ (Discount)	Net Amortization (Expense)
Q2: 2001	\$29,046	\$(36,230)	\$(7,184)	\$ (2,052)
Q3: 2001	27,921	(34,308)	(6,387)	(2,137)
Q4: 2001	26,518	(30,562)	(4,044)	(5,019)
Q1: 2002	23,036	(32,053)	(9,017)	(3,201)
Q2: 2002	31,155	(40,301)	(9,146)	(793)
Six Months: 2001	\$29,046	\$(36,230)	\$(7,184)	\$ (3,106)
Six Months: 2002	31,155	(40,301)	(9,146)	(3,994)

* Includes deferred bond issuance costs and net premium on Long-Term Debt throughout.

Market Value Risk

At June 30, 2002, we owned mortgage securities and loans totaling \$0.9 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, 86% had adjustable-rate coupons and the remaining 14% were hybrid loans.

At June 30, 2002, we owned \$0.5 billion of assets that were marked-to-market through our balance sheet but not through our income statement. Of these assets, 26% had adjustable-rate coupons, 42% were hybrid loans, and the remaining 32% had fixed-rate coupons. 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, although we expect to in the future. Please see our discussion above under "Interest Rate Risk" and in our Notes to our Consolidated Financial Statements for a more detailed description of our interest rate agreements. As of June 30, 2002, our interest rate agreements are reported at market value with any periodic changes reported through the income statement.

Capital Risk

Our capital levels, and thus our access to borrowings and liquidity, may be tested, particularly if market values of our assets that secure our short-term borrowings decline 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

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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 June 30, 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*

(a) The Annual Meeting of Shareholders of the Company was held on May 9, 2002.

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(b) The following matters were voted on at the Annual Meeting:

	Votes		
	For	Against	Abstain
1. Election of Directors			
Douglas B. Hansen	14,046,519	57,072	—
Charles J. Toeniskoetter	13,034,292	1,069,299	—

The following Directors' terms of office continue after the meeting:

Richard D. Baum
Thomas C. Brown
Mariann Byerwalter
George E. Bull
David L. Tyler

	Votes		
	For	Against	Abstain
2. Ratification of PricewaterhouseCoopers LLP as the Company's independent public accountants for the fiscal year ending December 31, 2002	14,010,949	67,035	25,338

	Votes		
	For	Against	Abstain
3. Approval of the Company's Incentive Stock Plan	13,503,032	530,930	69,629

	Votes		
	For	Against	Abstain
4. Approval of the Company's Employee Stock Purchase Plan	13,785,228	260,744	57,618

Item 5. Other Information

Pursuant to Section 202 of the Sarbanes-Oxley Act of 2002, the Company's Audit Committee has approved all auditing and non-audit services performed to date and currently planned to be provided in 2002 by the Company's auditors, PricewaterhouseCoopers LLP. The services include the annual audit, quarterly reviews, comfort letters in connection with debt and equity securities issuances, issuances of consents related to SEC-filings, and certain tax compliance services.

Item 6. Exhibits and Reports on Form 8-K

(a) *Exhibits*

Exhibit 4.4.4	Indenture dated as of April 1, 2002 between Sequoia Mortgage Trust 6 (a wholly-owned consolidated subsidiary of the Registrant) and Deutsche Bank National Trust Company, as Trustee(a)
Exhibit 4.4.5	Indenture dated as of April 1, 2002 between Sequoia Mortgage Funding Company 2002-A (a wholly-owned consolidated subsidiary of the Registrant) and The Bank of New York, as Trustee(b)
Exhibit 4.4.6	Indenture dated as of May 1, 2002 between Sequoia Mortgage Trust 7 (a wholly-owned consolidated subsidiary of Registrant) and HSBC Bank, USA, as Trustee(c)
Exhibit 10.15	2002 Incentive Stock Plan
Exhibit 10.16	2002 Employee Stock Purchase Plan
Exhibit 10.17	Executive Deferred Compensation Plan
Exhibit 11.1	Computation of Earnings Per Share for the three and six months ended June 30, 2002 and June 30, 2001.
Exhibit 99.1	Certificate of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Exhibit 99.2	Certificate of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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- (a) Incorporated by reference to the Form 8-K (1-13759) filed by Sequoia Mortgage Funding Corporation with the Securities and Exchange Commission on May 13, 2002.
 - (b) Incorporated by reference to the Form 8-K (1-13759) filed by Sequoia Mortgage Funding Corporation with the Securities and Exchange Commission on May 14, 2002.
 - (c) Incorporated by reference to the Form 8-K (1-13759) filed by Sequoia Mortgage Funding Corporation with the Securities and Exchange Commission on June 13, 2002.

(b) *Reports*

None.

2002 REDWOOD TRUST, INC.
INCENTIVE STOCK PLAN

SECTION 1. GENERAL PURPOSE OF PLAN; DEFINITIONS.

The name of this plan is the 2002 Redwood Trust, Inc. Incentive Stock Plan (the "Plan"). The Plan was adopted by the Board on March 21, 2002 and approved by the Company's stockholders on May 9, 2002. 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 to performance measures 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(8).

(2) "Administrator" means the Board, or as long as the Company is subject to the reporting requirements of the Securities Exchange Act of 1934, as amended, or as required under Section 162(m) of the Code, the Committee appointed by the Board.

(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(8).

(8) "DERs" shall mean dividend equivalent rights, in the form of Accrued DERs or 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 or on such other bases as the Administrator

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may determine.

(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 11.

(12) "Eligible Employee" means an employee of the Company or any Subsidiary, and any person to whom an offer of employment is made by 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) "GAAP" means, for any day, generally accepted accounting principles, applied on a consistent basis, stated in the opinions and pronouncements of the Accounting Principles Board and the American Institute of Certified Public Accountants, or in statements and pronouncements of the Financial Accounting Standards Board or in such other statements by another entity or entities as may be approved by a significant segment of the accounting profession, that are applicable to the circumstances for that day.

(16) "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.

(17) "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 6 below).

(18) "Non-Employee Director" shall have the meaning set forth in Rule 16b-3 promulgated under the Securities Exchange Act of 1934, as amended.

(19) "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.

(20) "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.

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(21) "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.

(22) "Prior Plan" means the Company's Amended and Restated 1994 Executive and Non-Employee Director Stock Option Plan.

(23) "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.

(24) "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 or on such other bases as the Administrator may determine.

(25) "Stock" means the common stock, \$0.01 par value, of the Company.

(26) "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.

(27) "Stock Option" means an option to purchase shares of Stock granted pursuant to Section 5 or Section 5A.

(28) "Subsidiary" means (A) any corporation (other than the Company) or other entity whose assets and liabilities are consolidated with those of the Company on the Company's consolidated balance sheet and (B) any other business venture designated by the Administrator in which the Company has a significant interest, as determined in the discretion of the Administrator.

SECTION 2. ADMINISTRATION.

The Plan shall be administered by the Administrator, except as otherwise expressly provided herein.

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 addition, the Administrator shall have the authority:

(a) to select those employees and prospective 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 may designate whether any award being granted to any Participant is intended to be "performance-based compensation" as that term is used in Section 162(m) of the Code. Any such awards designated as "performance-based compensation" shall be conditioned on the achievement of one or more performance measures. The performance measures that may be used by the Administrator for such awards shall be based on any one or more of the following, as selected by the Administrator: revenue; revenue per employee; GAAP earnings; taxable earnings; GAAP or taxable earnings per employee; GAAP or taxable earnings per share (basic or diluted); operating income; total stockholder return; dividends paid or payable; market share; profitability as measured by return ratios, including return on revenue, return on assets, return on equity, and return on investment; cash flow; or economic value added (economic profit); and such criteria generally must be specified in advance and may relate to one or any combination of two or more corporate, group, unit, division, affiliate, or individual performances. For awards intended to be "performance-based compensation," the grant of the awards, the establishment of the performance measures, and the certification that the performance goals were satisfied shall be made during the period and in the manner required under Code Section 162(m).

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) shares of Stock subject to awards granted to the Participant under the Prior Plan (whether such awards are then exercisable or vested), (iii) Stock Options, whether or not then exercisable, held by the Participant to purchase additional such shares, (iv) Restricted Stock, Deferred Stock, and Performance Share awards to the Participant, whether or not then vested, and (v) 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 shares of Stock for which awards may be granted under the Plan shall be subject to the following:

(1) Subject to the following provisions of this Section 3, the maximum number of shares of Stock with respect to which awards may be granted to Participants and their beneficiaries under the Plan shall be equal to the sum of: (i) 400,000 shares of Stock; (ii) 299,064 shares of Stock available for

future awards under the Prior Plan as of March 1, 2002; (iii) any shares of Stock that are represented by awards granted under the Prior Plan which are (A) forfeited, expire, or are canceled without delivery of shares of Stock or (B) settled in cash; and (iv) any shares of Stock that are represented by awards granted under the Prior Plan which are tendered to the Company (by either actual delivery or attestation) to satisfy the exercise price of Stock Options or the applicable tax withholding obligation.

(2) Any shares of Stock covered by an award that is forfeited or canceled, or shares of stock not delivered because the award is settled in cash or used to satisfy the applicable tax withholding obligation, shall not be deemed to have been granted for purposes of determining the maximum number of shares of Stock available for future awards under the Plan.

(3) If the exercise price of any Stock Option granted under the Plan is satisfied by tendering shares of Stock to the Company (by either actual delivery or by attestation), only the number of shares of Stock issued net of the shares of Stock tendered shall be deemed granted for purposes of determining the maximum number of shares of Stock available for future awards under the Plan.

(4) 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 be available for future awards under the Plan.

(5) Subject to Section 3(6), the following additional maximums are imposed under the Plan:

(a) The maximum number of shares of Stock that may be the subject of awards granted as Incentive Stock Options under the Plan shall be 500,000 shares (regardless of whether the awards are canceled, forfeited, or re-priced or the shares subject to any such award are surrendered).

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(b) The maximum number of shares that may be the subject of awards granted to any one individual pursuant to Sections 5 and 6 (relating to Stock Options and Stock Appreciation Rights and Limited Stock Appreciation Rights) shall be 500,000 shares during any calendar year (regardless of whether such awards are canceled, forfeited, or re-priced or the shares subject to any such award are surrendered).

(c) No more than 500,000 shares of Stock may be the subject of awards under the Plan granted to any one individual during any one-calendar-year period (regardless of when such shares are deliverable or whether the awards are forfeited, canceled, or re-priced or the shares subject to any such award are surrendered) if such awards are intended to be "performance-based compensation" (as the term is used for purposes of Code Section 162(m)).

(d) Shares of Stock issued under the Plan or covered by awards granted under the Plan pursuant to the settlement, assumption or substitution of outstanding awards or obligations to grant future awards as a condition of the Company acquiring another entity shall not count against the maximum number of shares available for future awards under the Plan.

(6) In the event of a corporate transaction involving the Company (including, without limitation, any stock dividend, stock split, extraordinary cash dividend, recapitalization, reorganization, merger, consolidation, split-up, spin-off, combination, or exchange of shares), the Administrator may adjust awards to preserve the benefits or potential benefits of the awards. Action by the Administrator may include: (i) adjustment of the number and kind of shares which may be delivered under the Plan; (ii) adjustment of the number and kind of shares subject to outstanding awards; (iii) adjustment of the exercise price of outstanding Stock Options, Stock Appreciation Rights, and Limited Stock Appreciation Rights; and (iv) any other adjustments that the Administrator determines to be equitable, in its sole discretion.

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 and provided further, however, that any grant made to any person to whom an offer of employment is made shall cease to be effective unless such person accepts such offer and commences employment with the Company or any Subsidiary within 90 days

after the date of the grant.

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(8). Any Stock Option granted under the Plan shall be in

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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 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. 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. 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. 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.

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(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. The Administrator may also permit a Participant to elect to pay the exercise price upon the exercise of a Stock Option by irrevocably authorizing a third party to sell shares of Stock (or a sufficient portion of the shares) acquired upon exercise of the Stock Option and remit to the Company a sufficient portion of the sale proceeds to pay the entire exercise price and any tax withholding resulting from such exercise. As determined by the Administrator, in its sole discretion, payment in whole or in part may also be made by surrendering 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.

(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 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

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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 Non-Qualified Stock 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 Stock Options shall be prohibited except those in accordance with Section 5(6)(a) or expressly approved by the Administrator. Following transfer, any such Stock 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) and 10(3) hereof, the terms "optionee," "Stock Option holder" and "Participant" shall be deemed to refer to the transferee. The events of termination of employment contained in the option agreement with respect to such Stock Options shall continue to be applied with respect to the original optionee, following any which event the Stock Options shall be exercisable by the transferee only to the extent, and for the periods specified in such option agreements. Notwithstanding the transfer, the original optionee will continue to be subject to the provisions of Section 10(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.

(7) 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

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first time by the optionee during any calendar year exceeds \$100,000, such Stock Options shall be treated as Non-Qualified Stock Options.

(8) 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 such other 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 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

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calendar year 2002, 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 as the Board may determine. 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. Each Stock Option granted to an

Eligible Non-Employee Director shall become exercisable on such date or dates as the Board may determine. 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 pursuant to any method described in Section 5(4) and no Stock Option shall be exercisable more than ten years after the date of grant. Any Stock Option issued under this Section may include DERs, in the discretion of the Board.

(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).

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.

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(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

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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 by the Administrator at the time of grant), 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 by the Administrator at the time of grant) 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, Deferred Stock, or Performance Share awards; the performance objectives applicable to Performance Share, Restricted Stock, or Deferred Stock awards; the date or dates on which restric-

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tions 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, or Performance Share awards 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 2002 Redwood Trust, Inc. Incentive Stock 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 by the Administrator at the time of the grant).

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(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, except as otherwise specified by the Administrator at time of grant, dividends declared during the Restricted Period with respect to the number of shares covered by a Deferred Stock award shall accrue 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.

The Board may amend, alter, or discontinue the Plan, but no amendment, alteration, or discontinuation (1) may impair the rights of a Participant under any award theretofore granted without such Participant's consent, or (2) without the approval of the stockholders:

(a) except as provided in Section 3, increase the total number of shares of Stock for which awards may be granted under the Plan;

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

(c) materially change the performance measures set forth in Section 2 of the Plan; or

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

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.

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SECTION 10. 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.

(5) The Administrator may permit or require a Participant to subject any award granted hereunder to any deferred compensation, deferred stock issuance, or similar plan that may be made available to Participants by the Company from time to time. The Administrator may establish such rules and procedures for participation in such deferral plans as it may deem appropriate, in its sole discretion.

SECTION 11. EFFECTIVE DATE OF PLAN.

The Plan became effective (the "Effective Date") on May 9, 2002, the date the Company's stockholders formally approved the Plan.

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SECTION 12. TERM OF PLAN

The Plan shall remain in full force and effect unless terminated by the Board or no further shares of Stock remain available for awards to be granted under Section 3 and there are no outstanding awards that remain to become vested, exercised, or free of restrictions.

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2002 REDWOOD TRUST, INC.
EMPLOYEE STOCK PURCHASE PLAN

1. ESTABLISHMENT OF PLAN.

Redwood Trust, Inc., a Maryland corporation (the "Company"), proposes to grant options ("Options") for purchase of the Company's common stock, \$0.01 per share par value ("Common Stock"), to eligible employees of the Company and its Designated Subsidiaries (as hereinafter defined) pursuant to this Employee Stock Purchase Plan (this "Plan"). For purposes of this Plan, "parent corporation" and "subsidiary" shall have the same meanings as "parent corporation" and "subsidiary corporation" set forth in Sections 424 (e) and 424 (f), respectively, of the Internal Revenue Code of 1986, as amended (the "Code"). The Company intends this Plan to qualify as an "employee stock purchase plan" under Section 423 of the Code (including any amendments or successor provisions to such Section), and the provisions of this Plan shall be construed as reasonably necessary in order to effectuate such intent. Any term not expressly defined in this Plan but defined for purposes of Section 423 of the Code shall have the same definition herein.

2. STOCK SUBJECT TO PLAN.

A total of 100,000 shares of the Common Stock is reserved for issuance under this Plan. Such number shall be subject to adjustments affected in accordance with Section 16 of this Plan. Any shares of Common Stock that have been made subject to an Option that cease to be subject to the Option (other than by means of exercise of the Option), including, without limitation, in connection with the cancellation or termination of an Option, shall again be available for issuance in connection with future grants of Options under this Plan.

3. PURPOSE.

The purpose of this Plan is to provide employees of the Company and its designated subsidiaries, as that term is defined in Section 5 of this Plan ("Designated Subsidiaries"), with a convenient means of acquiring an equity interest in the Company through payroll deductions, to enhance such employees' sense of participation in the affairs of the Company and its Designated Subsidiaries, to provide an incentive for continued employment with the Company and its Designated Subsidiaries, to provide an additional form of tax-advantaged compensation for employees, and to provide a performance incentive that will inure to the benefit of all of the Company's stockholders.

4. ADMINISTRATION.

This Plan shall be administered by a committee (the "Committee") appointed by the Company's Board of Directors (the "Board") consisting of at least two members of the Board, each of whom is a "non-employee director" as defined in Rule 16b-3 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") (unless the General Counsel of the Company shall have rendered a written opinion to the Board that such composition of the Committee is not required for the exemption under Rule 16b-3 to be available with respect to

purchases of Common Stock under the Plan), which shall be the Compensation Committee of the Board if it satisfies such requirements. Subject to the provisions of this Plan and the limitations of Section 423 of the Code or any successor provision in the Code, the Committee shall have exclusive authority, in its discretion, to determine all matters relating to Options granted under this Plan, including all terms, conditions, restrictions, and limitations of Options; provided, however, that all participants granted Options under an offering pursuant to this Plan shall have the same rights and privileges within the meaning of Code Section 423 (b) (5) except as required by applicable law. The Committee shall also have exclusive authority to interpret this Plan and may from time to time adopt rules and regulations of general application for this Plan's administration. The Committee's exercise of discretion and interpretation of this Plan, its rules and regulations, and all actions taken and determinations made by the Committee pursuant to this Plan shall be conclusive and binding on all parties involved or affected. The Committee may delegate administrative duties to the Plan Financial Agent (defined in Section 12) or such of the Company's officers or employees as it so determines (provided that no such delegation may be made that would cause the purchase of Common Stock by participants under this Plan to cease to be exempt from Section 16 (b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). All expenses incurred in connection with the administration of this Plan shall be paid by the Company and the Designated Subsidiaries; provided, however, that the Committee may require a participant to pay any costs or fees in connection with the sale by the participant of shares of Common Stock acquired under this Plan or in connection with the participant's request for the issuance of a certificate for shares of Common Stock held in the participant's account under the Plan.

5. ELIGIBILITY.

Any employee of the Company or the Designated Subsidiaries is eligible to participate in the Plan for any Offering Period (as hereinafter defined) under this Plan except the following:

(a) employees who have not been continuously employed by the Company or Subsidiaries from the date of hire or rehire or of return from an unapproved leave of absence for a period of at least three months before the beginning of such Offering Period;

(b) employees who are customarily employed for less than 20 hours per week;

(c) employees who are customarily employed for not more than five months in a calendar year; and

(d) employees who, together with any other person whose stock would be attributed to such employee pursuant to Section 424 (d) of the Code, own stock or hold options to purchase stock possessing five percent or more of the total combined voting power or value of all classes of stock of the Company or any of its Subsidiaries or who, as a result of being granted Options under this Plan, would own stock or hold options to purchase stock possessing five percent or more of the total combined voting power or value of all classes of stock of the Company or any of its Subsidiaries.

For all purposes of this Plan, the term Designated Subsidiaries shall mean those Subsidiaries listed on Annex A to this Plan or Subsidiaries which may hereafter be determined by the Committee or the Board to be Designated Subsidiaries. A Designated Subsidiary will

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cease to be a Designated Subsidiary on the earlier of (i) the date the Committee or the Board determines that such Subsidiary is no longer a Designated Subsidiary or (ii) such Designated Subsidiary ceases for any reason to be a "parent corporation" or "subsidiary corporation" as defined in Sections 424 (e) and 424 (f), respectively, of the Code.

6. EFFECTIVE DATE; OFFERING AND PURCHASE PERIODS.

The effective date of this Plan shall be July 1, 2002 (the "Effective Date"). The offering periods of this Plan (individually, an "Offering Period") shall consist of periods determined as described below not to exceed the maximum period permitted by Section 423 of the Code. Until determined otherwise by the Committee or the Board, (a) Offering Periods shall commence on each January 1 and continue for twelve months, provided, however, that the first Offering Period shall begin on July 1, 2002 and continue for six months and the initial Offering Period for any newly eligible employee that becomes a participant during an otherwise ongoing Offering Period shall be deemed to begin on the first day of the first Purchase Period after eligibility, and (b) each Offering Period shall consist of one or more purchase periods (individually, a "Purchase Period") during which payroll deductions of the participants are accumulated under this Plan. Until otherwise determined by the Committee or the Board, each Purchase Period shall be a three-month period commencing on each January 1, April 1, July 1, and October 1, provided, however, that the first Purchase Period shall commence with the first Offering Period on July 1, 2002. The first day of each Offering Period is referred to as the "Offering Date". The last day of each Purchase Period is referred to as the "Purchase Date". Subject to the requirements of Section 423 of the Code, the Committee or the Board shall have the power to change the duration of Offering Periods or Purchase Periods with respect to future offerings if such change is announced at least 30 days prior to the first day of the first Offering Period or Purchase Period to be affected by such change.

7. PARTICIPATION IN THIS PLAN.

Eligible employees may become participants in an Offering Period under this Plan as of the Purchase Period first commencing after satisfying the eligibility requirements by delivering an enrollment form provided by the Company to the Secretary of the Company or such other officer as he or she may designate from time to time ("Redwood Plan Administrator") not later than the 15th day of the month (or if such day is not a business day for the Company or the applicable Subsidiary, on the immediately preceding business day) before commencement of such Purchase Period unless a later time for filing the enrollment form authorizing payroll deductions is set by the Committee for all eligible employees with respect to a given Purchase Period. Notwithstanding the foregoing, for the initial Offering Period, commencing on the effective date, the time for filing an enrollment form and commencing participation for employees who satisfy the eligibility requirements as of the effective date shall be determined by the Committee and communicated to such employees. Once an employee becomes a participant in the Plan, such employee will automatically participate in all Purchase Periods commencing after satisfying the eligibility and enrollment requirements as set forth in the first sentence or second

sentence of this section unless the employee withdraws from this Plan or terminates further participation in the Offering Period as set forth in Sections 13 and 14 below. Such participant is not required to file any additional enrollment forms in order to continue participation in this Plan.

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8. GRANT OF OPTION ON ENROLLMENT.

Enrollment by an eligible employee in this Plan with respect to an Offering Period will constitute the grant by the Company to such employee as of the relevant Offering Date of an Option to purchase on each relevant Purchase Date up to that number of whole shares of Common Stock of the Company, determined by dividing (a) the amount accumulated in such employee's payroll deduction account during the Purchase Period ending on such Purchase Date by (b) the Purchase Price as that term is defined in Section 9; provided, however, that the number of shares which may be purchased pursuant to an Option may in no event exceed (i) the number determined by dividing the amount of \$6,250 by the fair market value (as defined in Section 9) of a share of Common Stock on the Offering Date, or (ii) such other maximum number of shares as may be specified in the future by the Board or Committee in lieu of the limitation contained in clause (i).

9. PURCHASE PRICE.

The purchase price per share (the "Purchase Price") at which a share of Common Stock will be sold on any Purchase Date shall initially be the LOWER of (a) 85 percent of the fair market value of such share on the first day of the Offering Period in which such Purchase Date occurs or (b) 85 percent of the fair market value of such share on the Purchase Date.

For purposes of this Plan, the term "fair market value" of the Common Stock on any date shall be the closing price on such date of the Common Stock reported on the New York Stock Exchange or any national securities exchange on which the Common Stock is listed. If there is no reported closing price of the Common Stock on such date, then the "fair market value" shall be measured on the next preceding trading day for which such reported closing price is available. If there is no regular trading market for the Common Stock, the fair market value of the Common Stock shall be as determined by the Committee in its sole discretion, exercised in good faith. The Committee may change the manner in which the Purchase Price is determined with respect to future Offering Periods or Purchase Periods (provided such determination does not have the effect of lowering the Purchase Price to an amount less than that which would be computed utilizing the method for determining the Purchase Price set forth in the first paragraph of this Section 9) if such changed manner of computation applied to all eligible employees and is announced at least 30 days prior to the first day of the first Offering Period or Purchase Period to be affected by such change.

10. PURCHASE OF SHARES; CHANGES IN PAYROLL DEDUCTIONS; ISSUANCE OF SHARES.

(a) Funds contributed by each participant for the purchase of shares under this Plan shall be accumulated by regular payroll deductions made during each Offering Period. The deductions shall be made in \$50 increments as selected by the Participant up to a maximum of not more than 15 percent of the participant's Compensation. As used herein, "Compensation" shall mean all base salary, wages, cash bonuses, commissions, current-pay dividend equivalent rights ("DERs"), and overtime; provided, however, that, for purposes of determining a participant's Compensation, any election by such participant to reduce his or her regular cash remuneration under Sections 125 or 401(k) of the Code shall be treated as if the participant did not make such election. "Compensation" does not include severance pay, hiring and relocation

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allowances, pay in lieu of vacation, automobile allowances, imputed income arising under any Company group insurance or benefit program, income received in connection with stock options or other stock-based awards (other than current-pay DERs), or any other special items of remuneration. Payroll deductions shall commence on the first payday following the Offering Date and shall continue through the last payday of the Offering Period unless sooner altered or terminated as provided in this Plan.

(b) A participant may lower (but not increase) the rate of payroll deductions during a Purchase Period by filing with the Redwood Plan Administrator a new authorization for payroll deductions, in which case the new rate shall become effective for the next payroll period commencing more than 15 days after the Redwood Plan Administrator's receipt of the authorization and shall continue for the remainder of the Offering Period unless changed as described below. Such change in the rate of payroll deductions may be made at any time during a Purchase Period, but not more than one change may be made effective during any Purchase Period. Notwithstanding the foregoing, a participant may lower the rate of payroll deductions to zero for the remainder

of the Purchase Period. A participant may increase or decrease the rate of payroll deductions for any subsequent Purchase Period by filing with the Redwood Plan Administrator a new authorization for payroll deductions not later than the 15th day of the month (or if such date is not a business day, the immediately preceding business day) before the beginning of such Purchase Period. A participant who has decreased the rate of withholding to zero will be deemed to continue as a participant in the Plan until the participant withdraws from the Plan in accordance with the provisions of Section 13. A participant shall have the right to withdraw from this Plan in the manner set forth in Section 13 regardless of whether the participant has exercised his or her right to lower the rate at which payroll deductions are made during an Offering Period.

(c) All payroll deductions made for a participant will be credited to his or her account under this Plan and deposited with the general funds of the Company. No interest will accrue on payroll deductions. All payroll deductions received or held by the Company may be used by the Company for any corporate purpose, and the Company shall not be obligated to segregate such payroll deductions.

(d) On each Purchase Date, provided that the participant has not terminated employment in accordance with Section 14 or has not submitted to the Redwood Plan Administrator a signed and completed withdrawal form, in either case on or before the 15th day (or if such date is not a business day, on the immediately preceding business day) of the last month of the Purchase Period in accordance with Section 10(b) or Section 13 of this Plan, or the Plan has not been terminated prior to the date referred to in the foregoing clause, the Company shall apply the funds then in the participant's account to the purchase at the Purchase Price of whole share(s) of Common Stock issuable under the Option deemed granted to such participant with respect to the Offering Period to the extent that such Option is exercisable on the Purchase Date; provided that in no event shall an Option be deemed exercised (by applying funds to a purchase) after the expiration of 27 months from the date such Option was deemed granted under Section 8 hereof. Subject to Section 11, any funds remaining in the participant's account will be applied to the following Purchase Period. No fractional shares will be purchased.

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(e) During a participant's lifetime, such participant's Option to purchase shares hereunder is exercisable only by him or her. The participant will have no interest or voting right in shares covered by his or her Option until such Option has been exercised.

11. LIMITATIONS ON RIGHT TO PURCHASE.

(a) No employee shall be granted an Option to purchase Common Stock under this Plan at a rate which, when aggregated with his or her rights to purchase stock under all other employee stock purchase plans of the Company or any Subsidiary which is intended to meet the requirements of Code Section 423, exceeds \$25,000 in fair market value, determined as of the applicable date of the grant of the Option, for each calendar year in which the employee participates in this Plan (or any other employee stock purchase plan described in this Section 11 (a)).

(b) The number of shares which may be purchased by any employee on a Purchase Date may not exceed the number of shares determined by dividing the sum of \$6,250 by the fair market value (as defined in Section 9) of a share of Common Stock on the first day of the Offering Period in which such Purchase Date occurs or, in the event the Committee or Board may specify a different limitation to be applied in lieu of the foregoing limitation, then the number of shares which may be purchased by any employee on a Purchase Date may not exceed such other limitation.

(c) If the number of shares to be purchased on a Purchase Date by all employees participating in this Plan exceeds the number of shares then available for issuance under this Plan, then the Company will make a pro rata allocation of the remaining shares in as uniform a manner as shall be reasonably practicable and as the Committee shall determine to be equitable. In such event, the Company shall give written notice of such reduction of the number of shares to be purchased under a participant's Option to each participant affected thereby.

(d) Any payroll deductions accumulated in a participant's account which are not used to purchase stock due to the limitations in this Section 11 shall be returned to the participant as soon as practicable after the end of the applicable Purchase Period without interest.

12. EVIDENCE OF STOCK OWNERSHIP.

(a) Promptly following each Purchase Date, the number of full shares of Common Stock purchased by each participant shall be deposited into an account established in the participant's name at a stock brokerage or other financial services firm designated or approved by the Committee (the "Plan Financial Agent"). A participant shall be free to undertake a disposition (whether by way

of sale, gift, or other transfer) of the shares in his or her account at any time, subject to the Company's Insider Trading Policy and applicable securities law rules and regulations, but, in the absence of such a disposition, the shares must remain in the participant's account at the Plan Financial Agent until the holding period set forth in Code Section 423 (a) has been satisfied. With respect to full shares for which the Code Section 423(a) holding period has been satisfied, the participant may move those shares to another brokerage account of the participant's choosing or request that a stock certificate for full shares be issued and delivered to him or her.

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(b) Following termination of a participant's employment for any reason, the participant shall have a period of 60 days to notify the Plan Financial Agent whether such participant desires (i) to receive a certificate representing all full shares then in the participant's account with the Plan Financial Agent and any cash being held for future purchases or (ii) to sell the shares in the participant's account through the Plan Financial Agent. If the terminated participant fails to file such notice with the Plan Financial Agent within 60 days after termination, he or she shall be deemed to have elected the alternative set forth in clause (i) above, provided that the Plan Financial Agent will continue to hold the terminated participant's certificates, on his or her behalf, in an account no longer subject to this Plan, until otherwise directed by such participant or determined by the Plan Financial Agent. However, the participant shall not in any event receive a certificate representing shares with respect to which the Code Section 423 (a) holding period has not been satisfied until such holding period has been satisfied.

13. WITHDRAWAL.

(a) Each participant may withdraw from an Offering Period under this Plan by signing and delivering to the Redwood Plan Administrator a written notice to that effect on a form provided for such purpose. Such withdrawal may be elected at any time on or prior to the 15th day of the last month (or if such date is not a business day, the immediately preceding business day) of a Purchase Period.

(b) Upon withdrawal from this Plan, the accumulated payroll deductions of the participant not theretofore utilized for the purchase of shares of Common Stock on a Purchase Date shall be returned to the withdrawn participant, without interest, and his or her participation in this Plan shall terminate. In the event a participant voluntarily elects to withdraw from this Plan, he or she may not resume his or her participation in this Plan during the same Offering Period unless otherwise determined by the Committee, but he or she may participate in any subsequent Offering Period by filing a new authorization for payroll deductions in the same manner as set forth above for initial participation in this Plan.

14. TERMINATION OF EMPLOYMENT; LEAVE OF ABSENCE.

Termination of a participant's employment for any reason, including retirement, death, or the failure of a participant to remain an eligible employee, immediately terminates his or her participation in this Plan. In such event, except as provided in Section 15, the payroll deductions credited to the participant's account will be returned to him or her or, in the case of his or her death, to his or her beneficiary or heirs, without interest. For purposes of this Section 14, an employee will not be deemed to have terminated employment or failed to remain in the continuous employ of the Company in the case of any leave of absence permitted by applicable law or otherwise approved by the Committee.

15. RETURN OF PAYROLL DEDUCTIONS.

In the event a participant's interest in this Plan is terminated by withdrawal, termination of employment, or otherwise, or in the event this Plan is terminated by the Board, the Company shall promptly deliver to the participant all contributions of the participant to the Plan which have not yet been applied to the purchase of stock unless such termination of participation occurs later than the 15th day of the final month of any Purchase Period (or if such date is not a business

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day, on the preceding business day), in which event such contributions will be utilized to purchase Common Stock for the participant. No interest shall accrue on the payroll deductions of a participant in this Plan.

16. CAPITAL CHANGES.

In the event that at any time or from time to time a stock dividend, stock split, spin-off, combination or exchange of shares, recapitalization, merger, consolidation, distribution to stockholders other than a normal cash dividend, or other change in the Company's corporate or capital structure

results in (a) the outstanding shares of Common Stock or any securities exchanged therefor or received in their place being exchanged for a different number or class of securities of the Company or of any other corporation or (b) new, different, or additional securities of the Company or of any other corporation being received by the holders of shares of Common Stock, then the Committee, in its sole discretion, shall make such equitable adjustments as it shall deem appropriate in the circumstances in the maximum number and kind of shares of stock subject to this Plan as set forth in Sections 1 and 2, the number and kind of shares subject to outstanding Options, and the Purchase Price. The determination by the Committee as to the terms of any of the foregoing adjustments shall be conclusive and binding.

17. NONASSIGNABILITY.

Neither payroll deductions credited to a participant's account nor any rights with regard to the exercise of an Option or to receive shares under this Plan may be assigned, transferred, pledged, or otherwise disposed of in any way (other than by will, the laws of descent and distribution, or as provided in Section 24 hereof) by the participant. Any such attempt at assignment, transfer, pledge, or other disposition shall be void and without effect.

18. REPORTS AND STATUS OF ACCOUNTS.

Individual accounts will be maintained by the Plan Financial Agent for each participant in this Plan. The participant shall have all ownership rights with respect to shares of Common Stock held in his or her account by the Plan Financial Agent, including the right to vote such shares and to receive any dividends or distributions which may be declared thereon by the Board. The Plan Financial Agent shall send to each participant promptly after the end of each Purchase Period a report of his or her account setting forth the total of shares purchased, the total number of shares then held in his or her account, and the market value per share. Neither the Company nor any Designated Subsidiary shall have any liability for any error or discrepancy in any such report.

19. NO RIGHTS TO CONTINUED EMPLOYMENT; NO IMPLIED RIGHTS.

Neither this Plan nor the grant of any Option hereunder shall confer any right on any employee to remain in the employ of the Company or any Subsidiary or restrict the right of the Company or any Subsidiary to terminate such employee's employment. The grant of any Option hereunder during any Offering Period shall not give a participant any right to similar grants thereafter.

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20. EQUAL RIGHTS AND PRIVILEGES.

All eligible employees shall have equal rights and privileges with respect to this Plan except as required by applicable law so that this Plan qualifies as an "employee stock purchase plan" within the meaning of Section 423 or any successor provision of the Code and the related regulations. Any provision of this Plan which is inconsistent with Section 423 or any successor provision of the Code shall, without further act or amendment by the Company, the Board, or the Committee, be reformed to comply with the requirements of Section 423. This Section 20 shall take precedence over all other provisions in this Plan.

21. NOTICES.

All notices or other communications by a participant to the Company under or in connection with this Plan shall be deemed to have been duly given when received in the form specified by the Company at the location, or by the person, designated by the Company for the receipt thereof.

22. AMENDMENT OF PLAN.

This Plan may be amended by the stockholders of the Company. The Board may also amend this Plan in such respects as it shall deem advisable; however, stockholder approval will be required for any amendment that will increase the total number of shares as to which Options may be granted under this Plan, or, but for such shareholder approval, cause this Plan to fail to continue to qualify as an "employee stock purchase plan" under Section 423 of the Code or cause the purchase of shares thereunder to fail to be exempt from the provisions of Section 16 (b) of the Exchange Act.

23. TERMINATION OF THE PLAN.

The Company's stockholders or the Board may suspend or terminate this Plan at any time. Unless this Plan shall theretofore have been terminated by the Company's stockholders or the Board, this Plan shall remain in full force and effect until all shares reserved under Section 2 have been purchased pursuant to the terms hereof.

24. DESIGNATION OF BENEFICIARY.

(a) A participant may file a written designation of a beneficiary who is to receive any shares and cash, if any, from the participant's account under this Plan in the event of such participant's death prior to delivery to him or her (or to the Plan Financial Agent on his or her behalf) of such shares and cash.

(b) Such designation of beneficiary may be changed by the participant at any time by written notice. In the event of the death of a participant and in the absence of a beneficiary validly designated under this Plan who is living at the time of such participant's death, the Company shall deliver such shares or cash to the executor or administrator of the estate of the participant, or if no such executor or administrator has been appointed (to the knowledge of the Company), the Company, in its discretion, may deliver such shares or cash to the spouse or to any one or more dependents or relatives of the participant or, if no spouse, dependent, or relative

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is known to the Company, to such other person as the Company may in good faith determine to be the appropriate designee.

25. CONDITIONS UPON ISSUANCE OF SHARES; LIMITATION ON SALE OF SHARES.

Shares shall not be issued with respect to an Option unless the exercise of such Option and the issuance and delivery of such shares pursuant thereto shall comply with all applicable provisions of law, domestic or foreign, including, without limitation, the Securities Act of 1933, as amended, the Exchange Act, the rules and regulations promulgated thereunder, and the requirements of the New York Stock Exchange or any stock exchange upon which the shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance.

26. WITHHOLDING.

The Committee shall have the right to make such provisions as it deems appropriate to satisfy any obligation of the Company to withhold federal, state, or local income or other taxes incurred by reason of the operation of the Plan.

27. GOVERNING LAW.

Except to the extent that provisions of this Plan are governed by applicable provisions of the Code or any other substantive provision of federal law, this Plan shall be construed in accordance with, and shall be governed by, the substantive laws of the State of California without regard to any provisions of California law relating to the conflict of laws.

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ANNEX A

LIST OF SUBSIDIARIES

Sequoia Mortgage Funding Corporation
RWT Holdings, Inc.
Redwood Commercial Funding, Inc.
Redwood Residential Funding, Inc.
Redwood Financial Services, Inc.
Sequoia Residential Funding, Inc.

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REDWOOD TRUST, INC.
EXECUTIVE DEFERRED COMPENSATION PLAN

The Board of Directors of Redwood Trust, Inc. a corporation, ("Company") has adopted this Executive Deferred Compensation Plan ("Plan") effective June 1, 2002.

1. PURPOSE

The primary purpose of the Plan is to provide the opportunity to defer compensation to a select group of management, highly compensated employees and independent directors. The plan is intended to be a top-hat plan described in Section 201(2) of the "ERISA".

2. DEFINITIONS AND CAPITALIZED TERMS

The capitalized terms, set forth in alphabetical order defined below, are used throughout the Plan.

- 5.2(a) (a) "Annual Base Salary" refers to the term defined in Section 5.2(a)
- (b) "Annual Bonus" refers to the term defined in Section 5.2(b).
- (c) "Beneficiary" refers to the term defined in Section 8.5.
- (d) "Board" or "Board of Directors" refers to the Board of Directors of the Company.
- (e) "Cash DERs" refers to DERs payable in cash.
- (f) "Change of Control" refers to the occurrence of any of the following:

(1) 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) 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 or in one or more transactions approved or consented to by the Board) representing 25% or more of the combined voting power of the Company's then outstanding securities; or

(2) 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 (1), (3) or (4) of this definition) 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

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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

(3) a merger or consolidation of the Company with any other corporation is consummated, 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 55% 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

(4) a sale or disposition by the Company of all or substantially all of the Company's assets is consummated; or

(5) the stockholders of the Company approve a plan of complete liquidation of the Company.

(g) "Code" refers to the Internal Revenue Code of 1986, as amended from time to time.

(h) "Committee" refers to the Company's Compensation Committee.

(i) "Company" refers to Redwood Trust, Inc. a Maryland corporation and any of its subsidiaries.

(j) "Compensation" refers to Annual Base Salary, Annual Bonus, Cash DERs, Incentive Payments, Retainers, Fees and such other bonuses and incentive payments as may be designated by the Committee under Section 5.2(f).

(k) "Deferral" means an amount of Compensation deferred pursuant to a Deferral Election.

(l) "Deferral Account" refers to the bookkeeping entries established and maintained by the Company for the purpose of recording (i) the amounts of Compensation deferred by a Participant, (ii) and interest and stock accruals with respect to those amounts, and (iii) any distributions to a Participant or Beneficiary.

(m) "Deferral Crediting Date" refers to the term defined in Section 6.1.

(n) "Deferral Election" means a Participant's irrevocable election to defer receipt of Compensation to a later Plan Year.

(o) "DERs" shall mean Dividend Equivalent Rights.

(p) "Director" refers to any non-management director of the Board of Directors of the Company.

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(q) "Distribution Date" means the date or dates on which Compensation being deferred will be distributed, as selected by the Participant on the Deferral Election form. The term Distribution Date does not include other dates on which amounts may be distributed to a Participant under the Plan such as upon total disability, death, Unforeseeable Financial Emergency, or termination of employment other than upon Retirement.

(r) "Effective Date" refers to June 1, 2002 with respect to Compensation first earned, determined or payable after that date.

(s) "Employee" refers to any employee, within the meaning of Section 3121(d) of the Code, who is highly compensated, has the title of Vice President, President or Chief Executive Officer, or is otherwise a member of management selected by the Committee to participate in this Plan. The Committee shall determine whether an employee is to be considered highly compensated, applying a definition with a dollar threshold at least as high as that set under Section 401(a) of the Code from time to time with respect to qualified plans. Where the Committee considers appropriate in applying the provisions of this Plan, the term Employee shall include only persons who are Participants or Inactive Participants under Plan.

(t) "ERISA" refers the Employee Retirement Income Security Act of 1974, as amended from time to time.

(u) "Fees" refers to meeting and other fees payable to Directors of the Company, in addition to Retainers.

(v) "GAAP" refers to generally accepted accounting principles, applied on a consistent basis, stated in the opinions and pronouncements of the Accounting Principles Board and the American Institute of Certified Public Accountants, or in statements and pronouncements of the Financial Accounting Standards Board or in such other statements by another entity or entities as may be approved by a significant segment of the accounting profession.

(w) "Inactive Participant" refers to an Employee who has elected to defer Compensation under the Plan during a previous Plan Year but who does not defer any Compensation payable during the current Plan Year.

(x) "Incentive Payment" refers to any payment of the Company's Common Stock due upon exercise of a non-qualified stock option under one of the stock-based incentive plans of the Company.

(y) "Interest Account" means the account under which interest is credited to a Participant's Deferral Account each Plan Year.

(z) "Interim Period" means with respect to any payment made to a Participant under the Plan, the period beginning January 1 of the year in which such payment is made and ending on the date of such payment.

(aa) "Interim Rate of Return" is the rate that is credited on amounts distributed from the Interest Account during a Plan Year for the period from January 1 of such Plan Year to

the date of distribution, as herein provided. The Interim Rate of Return will be designated by the Committee for each Deferral in the Deferral Election. In the absence of an alternative designation by the Committee, the default Interim Rate of Return shall be 8% per annum, as calculated on an actual daily uncompounded basis.

(bb) "Participant" refers to an Employee or Director who elects to defer under the Plan part or all of his or her Compensation payable during a Plan Year.

(cc) "Plan" means this Redwood Trust, Inc. Executive Deferred Compensation Plan.

(dd) "Plan Year" refers to the period of 12 consecutive months commencing on the first day of January of each year. The initial Plan Year shall commence on the Effective Date of the Plan and end on the final day of December of the same calendar year.

(ee) "Rate of Return" is the rate of return accrued with respect to a Plan Year on amounts held in the Interest Account at the end of such Plan Year. A specific formula for determining the Rate of Return calculation will be designated by the Committee for each Deferral in the Deferral Election. In the absence of an alternative designation by the Committee, the default Rate of Return shall be the average economic return -- as calculated annually for each calendar year of the Company (or, in the case of the initial Plan Year, for the period beginning on July 1, 2002 and ending December 31, 2002) -- that the Company earned as a percentage of its entire average capital base (including common, preferred, and other forms of equity, that portion of long-term unsecured debt that has a remaining maturity of at least one year past the end of the Plan year and is designated as capital by the Committee, deferred amounts under this Plan, and other forms of capital that may be designated by the Committee) before overhead, before variable stock option expense, and before payments made to capital (such as dividends, interest payments on debt designated as capital, and accruals for the deferred amounts under the Plan), less 1%. In no case shall the rate of return for a Plan year be less than 0%. The Committee shall, in good faith, estimate a reasonable measure of the Company's average pre-overhead marginal economic return on capital for each year by examining the Company's results. In the absence of a different determination by the Committee, the Company's GAAP accounting books shall be deemed an adequate estimate of economic return and GAAP accounting numbers shall be used to calculate the Rate of Return for the Plan. The Committee may adjust or modify the Company's GAAP results, or use a different measure of results, in order to achieve a better reasonable estimation of the Company's economic returns for the year (or, in the case of the initial Plan Year, the applicable portion thereof).

(ff) "Re-Deferral Election" means a Participant's irrevocable election to extend a Distribution Date.

(gg) "Retainer" refers to the annual fixed compensation amount, payable in cash to Directors, for each fiscal year of the Company or such portion thereof as they may serve as Directors.

(hh) "Retirement" means a Participant's amicable termination of employment with the Company after employment with the Company (including any subsidiary or affiliate of

the Company) for an aggregate period of not less than ten (10) years, or as otherwise defined by the Committee.

(ii) "Stock Equivalent Account" means the investment alternative under which a Participant's Deferral Account is treated as if it is invested in the Company's common stock.

(jj) "Unforeseeable Financial Emergency" refers to the term defined in Section 8.7.

3. ADMINISTRATION

The Plan shall be administered by the Committee, except as otherwise expressly provided herein. The Committee shall have the powers set forth in the Plan and the power to interpret its provisions. Any decisions of the Committee shall be final and binding on all persons with regard to the Plan. The Committee may delegate its authority hereunder to the President or any Vice President of the Company or to such other officers of the Company as it may deem appropriate, provided that no such officer shall be delegated authority to make decisions with respect to his or her own Deferrals or Deferral Account.

4. ELIGIBILITY

The Committee may, in writing from time to time, designate by name or title those Employees and Directors of the Company who are eligible to participate in the Plan for one or more Plan Years and the date upon which each such Employee's or Director's participation may commence. All designated Employees and Directors shall be notified in writing by the Board or the Committee of their eligibility to participate. No Employee or Director shall be entitled to participate in the Plan unless notified of their eligibility by the Committee. If the Committee provides a Participant with written notice of revocation of eligibility, the effective date of any such ineligibility shall be the first day of the Plan Year in which the notice is received or the next following Plan Year, as specified in the notice. A Participant's eligibility to participate in the Plan does not confer upon the Participant any right to any award, bonus, or other remuneration of any kind.

5. DEFERRAL OF COMPENSATION

5.1 Rules for Deferral Election. Any Employee or Director may make irrevocable elections to defer receipt of their Base Salary, Annual Bonus, Cash DERs, Incentive Payments, Retainers or Fees (each such election shall be referred to as a "Deferral Election" and the amount deferred pursuant to such an election the "Deferral") in accordance with the rules set forth below.

(a) An Employee or Director shall be eligible to make a Deferral Election only if he or she is an Employee or Director on the date such election is made.

(b) For each Plan Year, an Employee or Director may make no more than one Deferral Election for each year's Annual Base Salary, Annual Bonus and Retainer. An Employee or Director may make such number of Deferral Elections with respect to Cash DERs, Incentive Payments, or Fees as the Committee may prescribe.

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(c) All Deferral Elections must be made in writing on such forms as the Committee may prescribe and must be received by the Committee no later than the date specified by the Committee. In no event will the date specified by the Committee with (i) respect to an Annual Base Salary or Retainer be later than the end of the Plan Year preceding the Plan Year in which such Compensation is anticipated to be paid or (ii) with respect to an Annual Bonus be later than June 30 of the year the bonus is anticipated to be earned. Any Deferral Election with respect to a Participant's Incentive Payments, Cash DERs, or Fees, shall only apply to that portion of the foregoing remaining to be paid after the date the Deferral Election is made.

(d) As part of each Deferral Election, the Employee or Director must specify the Distribution Date or Dates on which the Deferral will be paid. The Distribution Dates specified in an Employee's or Director's Deferral Elections may, but need not necessarily, be the same for all Deferrals. Except as provided in subsection (g) below, each Distribution Date is irrevocable and shall apply only to that portion of the Participant's Deferral Account which is attributable to that Deferral.

(e) Except for lump sum distributions at Retirement, a Distribution Date must be May 1, so as to provide for the final audit and reporting of performance for the prior year to be completed.

(f) The earliest Distribution Date selected by an Employee or Director for any Compensation deferred under the Plan shall not be earlier than the May 1 that occurs 16 months after the end of the Plan Year during which the Deferral Crediting Date for such Compensation occurs.

(g) A Participant may elect to extend the Distribution Date or Dates and/or change the method of payment (lump sum or installments) relating to any Deferral Election (a "Re-Deferral Election"); provided, that no Re-Deferral Election shall be effective unless (i) the Committee receives the election prior to the December 31 of the Plan Year preceding the Plan Year in which the first Distribution Date to be changed occurs, and (ii) any new first Distribution Date is at least one year later than the initial first Distribution Date or constitutes a Distribution Date for a lump sum distribution following Retirement. No Deferral Election may be made the subject of more than one Re-Deferral Election to extend the Distribution Date or Dates and, in addition, one Re-Deferral Election to change the method of payment. All Re-Deferral Elections must be made in writing on such forms and pursuant to such rules as the Committee may prescribe.

(h) As part of each Deferral Election, an Employee or Director must elect the form in which the Deferral will be paid beginning on the selected Distribution Date. The Deferral may be paid in a single lump sum or in annual installments over a period not exceeding fifteen years as provided under Section 8.1. Except as provided in subsection (g) above and Section 8.1, an Employee's or Director's election as to the time and method of payment shall be irrevocable.

(i) As part of each Deferral Election, an Employee or Director must elect the investment alternatives that shall apply to the Deferral in accordance with Section 6.2.

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(j) A Deferral Election shall be irrevocable; provided, that (A) a Participant may elect to discontinue deferral of future unaccrued Compensation (other than Annual Bonus and Incentive Payments) at any time during the Plan Year and (B) if the Committee determines that a Participant has an Unforeseeable Financial Emergency (as defined in Section 5.7) and such Participant receives distributions from his or her Deferral Account as a result thereof, then the Participant's Deferral Elections then in effect shall be revoked with respect to all future accrued Compensation (other than Annual Bonus and Incentive Payments) covered thereby. A Participant that elects to discontinue deferrals under (A) above will not be eligible to make a new Deferral Election with respect to such type of Compensation until the next applicable date specified for such type of Compensation under subsection (c) above.

(k) Notwithstanding any provision to the contrary in this Section 5.1, a Participant may make a Deferral Election (i) with respect to unearned Annual Base Salary or Retainer for the year 2002 no later than the 30th day after the Effective Date of the Plan and (ii) with respect to unearned Annual Base Salary, Annual Bonus or Retainer for the year in which the Participant first becomes eligible to participate in the Plan, no later than the 30th day after the date such Participant becomes eligible to participate in the Plan.

(l) Notwithstanding any other provision of the Plan, the Committee may refuse, in its sole discretion, to accept any Deferral Election from a Participant regardless of such Participant's eligibility to participate in the Plan at the time.

5.2 Amounts Deferred. An Employee or Director may make a Deferral Election to defer receipt of the following amounts:

(a) All or any portion of the Employee's Annual Base Salary. "Annual Base Salary" shall mean the regular rate of compensation to be paid to the Employee for services rendered during the Plan Year excluding severance or termination payments, commissions, foreign service payments, payments for consulting services and such other unusual or extraordinary payments as the Committee may determine.

(b) All or any portion of the Employee's annual bonus for a year due under an annual bonus plan or any other short-term incentive plan of the Company (an "Annual Bonus").

(c) All or any portion of Cash DERs payable to the Participant.

(d) All or any portion of Incentive Payments payable to the Participant.

(e) All or any portion of the Director's Retainer or Fees.

(f) Such other payments, bonuses, and incentive payments under any plan or arrangement established by the Company or as the Committee may designate as compensation eligible for deferral under this Plan in such increments and subject to such limitations and restrictions as the Committee may establish.

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6. DEFERRAL ACCOUNTS

6.1 Deferral Accounts. All amounts deferred pursuant to a Participant's Deferral Elections under the Plan shall be allocated to a bookkeeping account in the name of the Participant ("Deferral Account") and the Committee shall maintain a separate subaccount under a Participant's Deferral Account for each Deferral. Deferrals shall be credited to the Deferral Account as of the Deferral Crediting Date coinciding with or next following the date on which, in the absence of a Deferral Election, the Participant would otherwise have received the Deferral. A "Deferral Crediting Date" shall mean the business day coinciding with or next following the date the Compensation being deferred would otherwise have been received by the Participant.

6.2 Investment Alternatives. A Participant must make an investment election at the time of each Deferral Election. The investment election must be made in writing on such forms and pursuant to such rules as the Committee may prescribe, subject to paragraph 6.3, and shall designate the portion of the Deferral which is to be treated as invested in each investment

alternative. The two investment alternatives shall be as follows:

(a) Stock Equivalent Account. Under the Stock Equivalent Account, the value of the Participant's Deferral shall be determined as if the Deferral were invested in the Company's common stock as of the Deferral Crediting Date. For all Deferrals other than Deferrals of Incentive Payments, the number of shares of common stock equivalents to be credited to the Participant's Deferral Account and appropriate subaccounts on each Deferral Crediting Date shall be determined by dividing the Deferral to be "invested" on that date by the closing price of the Company's common stock on the New York Stock Exchange Composite Transaction Tape on the business day preceding the Deferral Crediting Date ("Market Value"). Fractional stock equivalents will be computed to two decimal places. In the case of Deferrals of Incentive Payments, the number of shares of common stock equivalent shares to be credited to the Deferral Account shall be the number of shares of common stock which would otherwise have been payable under the Incentive Payment to the Participant on or prior to the Deferral Crediting Date but as to which the Participant has elected to defer delivery pursuant to the terms of the Plan. An amount equal to the number of common stock equivalents multiplied by the dividend paid per share on the Company's common stock on each dividend record date shall be payable in cash to the Participant on the related dividend payment date. The Participant may elect at the time of the Deferral Election to have such amount credited to the Interest Account. Except as the Committee may otherwise permit upon request of the Participant, the number of shares of the Company's common stock to be paid to a Participant on a Distribution Date with respect to any Deferral subaccount in the Stock Equivalent Account shall be equal to the number of common stock equivalents accumulated in the Deferral subaccount as of such Distribution Date divided by the total number of payments remaining to be made from such Deferral subaccount. Shares of common stock paid in respect of an Incentive Payment Deferral shall be deemed to be issued and delivered pursuant to the incentive plan of the Company under which such Incentive Payment was granted; all other shares paid to Participants shall be deemed to be issued and delivered pursuant to this Plan. All payments from the Stock Equivalent Account shall be made in whole shares of the Company's common stock with fractional shares credited to federal income taxes withheld.

(b) Interest Account. Under the Interest Account, interest will be credited to each subaccount in the Participant's Deferral Account once per year as of each

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January 1 (a "Valuation Date"). The rate of interest to be applied on each Valuation Date shall be the Rate of Return for the most recent calendar year ended prior to such Valuation Date. The Rate of Return shall be applied to the average balance in each subaccount during such prior fiscal year, such average balance to be computed on an actual daily basis and excluding any amounts distributed during such prior fiscal year to the Participant. Calculation of the interest credits shall be made as soon as practicable following the completion of the independent accountant's audit of the Company's financial statements each year and the Committee's determination of the proper Rate of Return for that year, and application of the interest credits will be effective as of the applicable Valuation Date. Any Participant's distributions made prior to the completion of the Committee's determination of the Rate of Return shall be based upon the conservative estimate by the Chief Financial Officer of the Company of the credits to be applied, if any, once the Committee has determined the Rate of Return, and following the Committee's determination of any adjustments necessary to reflect the proper credits will be made with the Participant on May 1 of that year. With respect to the distribution of a Deferral subaccount in the Interest Account, except as the Committee may otherwise permit upon request of the Participant, the amount to be paid to the Participant from such subaccount on a Distribution Date shall be the sum of (A) an amount determined by dividing the balance in the subaccount as of the latest Valuation Date (including interest accrued through the latest Valuation Date) by the total number of payments remaining to be made from such Deferral subaccount and (B) interest accrued during the Plan Year of distribution on the amount determined under (A) for the Interim Period at the Interim Rate of Return. Each lump sum payment, each installment payment and any other payment of balances in the Participant's Interest Account shall be accompanied by an amount of accrued interest on such payment at the Interim Rate of Return for the Interim Period. All payments from the Interest Account shall be made in cash.

6.3 Investment Elections and Changes. A Participant's investment elections shall be subject to the following rules:

(a) Except as provided in subsection (b) below with respect to Incentive Payments that would have been paid in the form of the Company's common stock, if the Participant fails to make an investment election with respect to a Deferral, the Deferral shall be deemed to be invested in the Interest Account.

(b) Any Deferral attributable to an Incentive Payment in the form of the Company's common stock, restricted or otherwise, shall automatically be deemed to be invested in the Stock Equivalent Account.

(c) Except as provided in subsection (b) above, with respect to the Deferrals designated in a Deferral Election but not yet deferred and invested under the Plan, a Participant may make a one-time, irrevocable change per Deferral Election in the investment election for all or a portion of the Deferrals covered by such Deferral Election from the Interest Account to the Stock Equivalent Account or from the Stock Equivalent Account to the Interest Account by filing an investment change election with the Committee, provided that such investment change election shall not be effective unless the election is received by the Committee prior to the December 31 of the Plan Year preceding the Plan Year in which the first Deferral Crediting Date with respect to such Deferrals is set to occur.

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(d) With respect to the Deferrals designated in a Deferral Election, a Participant may make a one-time, irrevocable election per Deferral Election to transfer all or a portion of such Deferrals invested in the Interest Account to the Stock Equivalent Account as of the first day of any calendar quarter by filing an investment change election with the Committee, provided that such investment change election shall not be effective unless the election is received by the Committee prior to the date it is to become effective and prior to the December 31 of the Plan Year preceding the Plan Year in which the first Distribution Date with respect to the Deferral Election being changed is set to occur. The amount elected to be transferred to the Stock Equivalent Account shall be treated as invested in the Company's common stock equivalents as of the first day of such quarter and the number of the shares of common stock equivalents to be credited to the Participant's Deferral Account and appropriate subaccounts as of such date shall be determined by dividing the amount to be transferred by the Market Value on such date.

6.4 Vesting. Except as otherwise provided by the Committee at the time of the Deferral Election, a Participant shall be fully vested at all times in the balance of his Deferral Account. The Committee may condition awards of Compensation from time to time on the Participant's consent to defer all or a portion thereof under the Plan. The Committee may also establish vesting requirements or other conditions with respect to awards of Compensation to be deferred under the Plan, as specified in the Deferral Election form. For any amounts deferred under the Plan that are subject to vesting requirements or other conditions, the Committee shall specify how unvested balances are to be treated under the Plan for purposes of interest accruals and dividend equivalent payments as well as distributions of balances.

7. EFFECT ON EMPLOYEE BENEFITS

Amounts deferred under this Plan or distributed pursuant to the terms of this Plan are not taken into account in the calculation of an Employee's benefits under any employee pension or welfare benefit program or under any other compensation practice maintained by the Company, except to the extent provided in such program or practice.

8. PAYMENT OF DEFERRAL ACCOUNTS

8.1 Time of Payment. Payment of a Participant's Deferral shall be made in a single lump sum or shall commence in installments as elected by the Participant in the Deferral Election. If a Participant's Deferral Account is payable in a single lump sum, the payment shall be made as soon as practicable following the applicable Distribution Date. If a Participant's Deferral is payable in installment payments, then the Participant's Deferral shall be paid in annual installments as determined under Section 6.2 over the period as elected by the Participant in the Deferral Election commencing as soon as practicable following the applicable Distribution Date.

8.2 Payment Upon Total Disability. In the event a Participant becomes totally disabled before all amounts credited to his Deferral Account have been paid, payment of the Participant's Deferral Account shall be made or shall commence in the form of payment elected by the disabled Participant, provided, that the disabled Participant requests payment in writing within 180 days of becoming disabled. If such a request is not made, the disabled Participant's Deferrals will be paid pursuant to such Participant's Deferral Elections and the normal

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provisions of the Plan. A Participant will be considered to be totally disabled for purposes of the Plan if the Participant is determined to be totally disabled under the Company's disability plan applicable to the Participant.

8.3 Payment Upon Retirement or Other Termination of Employment. A Participant's Deferral Account shall continue to be maintained for the benefit of the Participant and Deferrals shall be paid in accordance with the Participant's Deferral Elections in the event the Participant retires. Following Retirement, a Participant will continue to have the right to make Re-Deferral

Elections and investment change elections as provided herein, to the extent not exercised prior to Retirement. If the Participant terminates employment with the Company for any reason other than Retirement, total disability, or death before the entire balance in the Participant's Deferral Account has been paid, the balance in the Deferral Account shall be distributed in a single lump sum as soon as practicable.

8.4 Payment Upon Death of a Participant. In the event a Participant dies before all amounts credited to his Deferral Account have been paid, payment of the Participant's Deferral Account shall be made or shall commence in the form of payment elected by the Participant's Beneficiary or the Executor/Executrix of the Participant's estate, provided, that such party submits a request in writing within 180 days of the Participant's death. If such a request is not made, the deceased Participant's Deferrals will be paid to the Beneficiary pursuant to such Participant's Deferral Elections and the normal provisions of the Plan.

8.5 Beneficiary. A Participant's Beneficiary shall mean the individual(s) or entity designated by the Participant to receive the balance of the Participant's Deferral Account in the event of the Participant's death prior to the payment of his entire Deferral Account. To be effective, any Beneficiary designation shall be filed in writing with the Committee. A Participant may revoke an existing Beneficiary designation by filing another written Beneficiary designation with the Committee. The latest Beneficiary designation received by the Committee shall be controlling. In the event a married Participant designates someone other than his or her spouse as sole, primary beneficiary, such initial designation or subsequent change shall be invalid unless the spouse consents in a writing which names the designated Beneficiary. If no Beneficiary is named by a Participant or if he survives all of his named Beneficiaries, the Deferral Account shall be paid in the following order of precedence:

(a) the Participant's spouse or qualified domestic partner;

(b) the Participant's children (including adopted children), per stirpes; or

(c) the Participant's estate.

8.6 Form of Payment. The payment of that portion of a Deferral deemed to be invested in the Interest Account shall be made in cash. The distribution of that portion of a Deferral deemed to be invested in the Stock Equivalent Account shall be distributed in whole shares of the Company's common stock with fractional shares credited to federal income taxes withheld.

8.7 Unforeseeable Financial Emergency. If the Committee or its designee determines that a Participant has incurred an Unforeseeable Financial Emergency (as defined

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below), the Participant may withdraw in cash and/or stock the portion of the balance of his Deferral Account needed to satisfy the Unforeseeable Financial Emergency, to the extent that the Unforeseeable Financial Emergency may not be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the Participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship. An "Unforeseeable Financial Emergency" is a severe financial hardship to the Participant resulting from (i) a sudden and unexpected illness or accident of the Participant or of a spouse or dependent of the Participant; (ii) loss of the Participant's property due to casualty; or (iii) such other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the Participant. A withdrawal on account of an Unforeseeable Financial Emergency shall not exceed the amount reasonably needed to satisfy the emergency. Withdrawals shall be paid as soon as possible following the date on which the withdrawal is approved in writing by the Committee setting forth the grounds therefor.

8.8 Early Withdrawal with Penalty. Notwithstanding the other provisions of the Plan to the contrary, a Participant may request a withdrawal from his Deferral Account by filing a request with the Committee or its designee in writing. Payment will be made to the Participant within five days of the approval of such a request. Any withdrawal under this provision will be charged with a 10 percent early withdrawal penalty which will be withheld from the amount withdrawn.

8.9 Withholding of Taxes. The Company shall withhold any applicable Federal, state or local income tax from payments due under the Plan. The Company shall also withhold any applicable Social Security taxes, including the Medicare portion of such taxes, and any other employment taxes as necessary in its view based on the advice of counsel to comply with applicable laws and the Company's standard practices.

8.10 Small Amounts. Notwithstanding any election by a Participant

regarding the timing and manner of payment of his Deferrals, in the event of a Participant's Retirement, death or total disability, the Employer may elect to pay the Participant (or the Participant's Beneficiary) a lump sum distribution of the entire value of the Participant's Deferral Account if the value of such account is less than ten thousand dollars (\$10,000) determined as of the Valuation Date coinciding with or immediately following the Participant's Retirement, death or total disability.

8.11 Income Tax Obligations. If a Participant is assessed Federal, state or local income taxes by reason of, and computed on the basis of, his or her undistributed deferred Compensation or undistributed interest accrued on his or her Deferral Account, the Participant shall notify the Committee in writing of such assessment and there shall be distributed from the Participant's Deferral Account deferred Compensation or accrued interest in an amount equal to such tax assessment, together with any interest due and penalties assessed thereupon within 30 days following such notice; provided however, that if the Committee determines that such assessment is improper, it may request that the Participant contest the assessment, at the expense of the Company (which expense shall include all costs of appeal and litigation, including legal and accounting fees, and any additional interest assessed on the deficiency from and after the date of the Participant's notice to the Committee); and during the period such contest is pending, the sums otherwise distributable pursuant to this Section 8.11 shall not be distributed.

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8.12 Capital Changes. In the event that at any time or from time to time a stock dividend, stock split, spin-off, combination or exchange of shares, recapitalization, merger, consolidation, distribution to stockholders other than a normal cash dividend, or other change in the Company's corporate or capital structure results in (a) the outstanding shares of common stock or any securities exchanged therefor or received in their place being exchanged for a different number or class of securities of the Company or of any other corporation or (b) new, different, or additional securities of the Company or of any other corporation being received by the holders of shares of common stock, then the Committee, in its sole discretion, shall make such equitable adjustments as it shall deem appropriate in the circumstances in the number and kind of shares of stock equivalents contained in each Participant's Stock Equivalent Account.

9. FUNDING

Benefits payable under the Plan to any Participant shall be paid directly by the Company. The Company shall not fund, or otherwise segregate assets to be used for payment of benefits under, the Plan. Participants acknowledge that the Company intends to use the amounts deferred under this Plan as capital.

10. ACCOUNT STATEMENTS

As soon as practical after May 1 of each calendar year (or after such additional date or dates as the Committee, in its discretion, may designate), each Participant shall be provided with a statement of the balance of his Deferral Account hereunder as of the last day of the prior calendar year (or as of such other dates as the Committee, in its discretion, may designate).

11. EMPLOYMENT RIGHTS

Establishment of the Plan shall not be construed to give any Employee the right to be retained in the Company's service or to any benefits not specifically provided by the Plan. An Employee's election to participate in the Plan shall not affect the rights of the Employee under any employee agreement, stock option, or other incentive compensation agreement or to any other benefits to which the Employee is entitled.

12. INTERESTS NOT TRANSFERABLE

Except as to withholding of any tax under the laws of the United States or any state or locality and the provisions of Section 13, no benefit payable at any time under the plan shall be subject in any manner to alienation, sale, transfer, assignment, pledge, attachment or other legal process, or encumbrance of any kind. Any attempt to alienate, whether currently or thereafter payable, shall be void. No person shall, in any manner, be liable for or subject to the debts or liabilities of any person entitled to such benefits. If any person shall attempt to, or shall alienate, sell, transfer, assign, pledge or otherwise encumber his benefits under the Plan, or if by any reason of his bankruptcy or other event happening at any time, such benefits would devolve upon any other person or would not be enjoyed by the person entitled thereto under the Plan, then the Committee, in its discretion, may terminate the interest in any such benefits of the person entitled thereto under the Plan and hold or apply them for or to the benefit of such person entitled thereto under the terms of this Plan or his spouse, children or other dependents, or any of them, in such manner as the Committee may deem proper.

13. FORFEITURE

Unclaimed amounts shall consist of the amounts of the Deferral Account of a Participant that are not distributed because of the Committee's inability, after a reasonable search, to locate a Participant or his Beneficiary, as applicable, within a period of two (2) years after the Distribution Date upon which the payment of any benefits becomes due. No interest will be credited on such amounts invested in the Interest Account following such Distribution Date and no dividend equivalent payments will accrue on such amounts invested in the Stock Equivalent Account after such Distribution Date. Unclaimed amounts shall be forfeited at the end of such two-year period. These forfeitures will reduce the obligations of the Company under the Plan and the Participant or Beneficiary, as applicable, shall have no further right to his Deferral Account.

14. CONTROLLING LAW

This plan shall be construed in accordance with the laws of the State of California (exclusive of its rules regarding conflicts of law) to the extent that such laws are not preempted by ERISA or other federal laws. If any provision of this Plan shall be held illegal or invalid for any reason, such determination shall not affect the remaining provisions of this Plan which shall be construed as if said illegal or invalid provision had never been included.

15. ACTION BY THE COMPANY

Except as otherwise specifically provided herein, any action required of or permitted by the Company under the Plan shall be by resolution of the Board of Directors of the Company or by action of any member of the committee or person(s) authorized by resolution of the Committee.

16. AMENDMENT OR TERMINATION OF PLAN

(a) The Company intends the Plan to be permanent, but reserves the right at any time by action of its Board of Directors to terminate the Plan. The Board of Directors may also modify or amend the Plan and outstanding Deferral Elections, provided, however, that any such modification or amendment shall not reduce or eliminate any Deferral Account accrued through the date of such modification or amendment or otherwise impair the rights of a Participant under any Deferral Elections made prior to the date of such modification or amendment without such Participant's consent. The Committee shall have the same authority to modify or amend the Plan and outstanding Deferral Elections as the Board of Directors of the Company in the following circumstances:

(i) to adopt amendments to the Plan and outstanding Deferral Elections which the Committee determines are necessary or desirable for the Plan and outstanding Deferral Elections to comply with or to obtain benefits or advantages under the provisions of applicable law, regulations or rulings or requirements of the Internal Revenue Service or other governmental or administrative agency or changes in such law, regulations, rulings or requirements; and

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(ii) to adopt any other procedural or cosmetic amendment that the Committee determines to be necessary or desirable that does not materially change benefits to Participants or their Beneficiaries or materially increase the Company's obligations under the Plan.

(b) The Committee shall provide notice of amendments adopted by the Committee to the Board of Directors of the Company on a timely basis.

(c) This Plan shall terminate immediately if a court of competent jurisdiction determines that this Plan is not exempt from the fiduciary provisions of Part 4 of Title I of ERISA. The Plan shall terminate as of the date it ceased to be exempt.

(d) This Plan shall terminate immediately upon the occurrence of a Change of Control.

(e) Upon termination of the Plan, the Committee shall distribute as soon as practicable following such termination all Deferral Accounts, as determined by the Committee in a lump sum to all Participants.

17. MISCELLANEOUS

17.1 Alternative Acts and Times. If it becomes impossible or burdensome for the Company or the Committee to perform a specific act at a specific time required by this Plan, the Company or Committee may perform such alternative act which most nearly carries out the intent and purpose of this Plan and may perform such required or alternative act at a time as close as administratively feasible to the time specified in this Plan for such

performance. Nothing in the preceding sentence shall allow the Company or Committee to accelerate or defer any payments to Participants or Inactive Participants under this Plan, except as otherwise expressly permitted herein.

17.2 Masculine and Feminine, Singular and Plural. Whenever used herein, pronouns shall include both genders, and the singular shall include the plural, and the plural shall include the singular, whenever the context shall plainly so require.

17.3 Notices. Any notice from the Company or the Committee to an Employee, Participant, Inactive Participant or Beneficiary regarding this Plan may be addressed to the last known residence of said person as indicated in the records of the Company. Any notice to, or any service of process upon, the Company or the Committee with respect to this Plan may be addressed as follows:

Chief Financial Officer
Redwood Trust, Inc.
591 Redwood Highway
Suite #3100
Mill Valley, CA 94941

17.4 Facility of Payment. If the Committee, in its sole discretion, determines that any Employee, Participant, Inactive Participant or Beneficiary by reason of infirmity,

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minority or other disability, is physically, mentally or legally incapable of giving a valid receipt for any payment due him or her or is incapable of handling his or her own affairs and if the Committee is not aware of any legal representative appointed on his or her behalf, then the Committee, in its sole discretion, may direct (a) payment to or for the benefit of the Employee, Director, Participant, Inactive Participant or Beneficiary; (b) payment to any person or institution maintaining custody of the Employee, Director, Participant, Inactive Participant or Beneficiary; or (c) payment to any other person selected by the Committee to receive, manage and disburse such payment for the benefit of the Employee, Director, Participant, Inactive Participant or Beneficiary. The receipt by any such person of any such payment shall be a complete acquittance therefore; and any such payment, to the extent thereof, shall discharge the liability of the Company, the Committee, and the Plan for any amounts owed to the Employee, Director, Participant, Inactive Participant or Beneficiary hereunder. In the event of any controversy or uncertainty regarding who should receive or whom the Committee should select to receive any payment under this Plan, the Committee may seek instruction from a court of proper jurisdiction or may place the payment (or entire Deferral Account) into such court with final distribution to be deemed by such court.

17.5 Correction of Errors. Any crediting of Compensation or interest accruals to the Deferral Account of any Employee, Director, Participant, Inactive Participant or Beneficiary under a mistake of fact or law shall be returned to the Company. If an Employee, Director, Participant, Inactive Participant or Beneficiary in an application for a benefit or in response to any request by the Company or the Committee for information, makes an erroneous statement, omits any material fact, or fails to correct any information previously furnished incorrectly to the Company or the Committee, or if the Committee makes an error in determining the amount payable to an Employee, Director, Participant, Inactive Participant or Beneficiary, the Company or the Committee may correct its error and adjust any payment on the basis of correct facts. The amount of any overpayment or underpayment may be deducted from or added to the next succeeding payments, as directed by the Committee. The Committee and the Company reserve the right to maintain any action, suit or proceeding to recover any amounts improperly or incorrectly paid to any person under the Plan or in settlement of a claim or satisfaction of a judgment involving the Plan.

17.6 Status of Participants. In accordance with Revenue Procedure 92-65 Section 3.01, this Plan hereby provides:

(a) Employees, Directors, Participants and Inactive Participants under this Plan shall have the status of general unsecured creditors of the Company;

(b) This plan constitutes a mere promise by the Company to make benefit payments in the future; and

(c) It is the intention of the parties that the arrangements under this plan shall be unfunded for tax purposes and for purposes of Title I of ERISA.

17.7 Employee and Spouse Acknowledgement. By executing this Plan document or related enrollment or election form, the undersigned Employee or Director and, if Employee or Director is married, Employee's or Director's spouse hereby acknowledge that each of them has read and understood this Plan document. Employee or Director and his or her

spouse also acknowledge that they knowingly and voluntarily agree to be bound by the provisions of the Plan, as amended from time to time, including those Plan provisions which require the resolution of disputes by binding out-of-court arbitration. Employee or Director and his or her spouse further acknowledge that they have had the opportunity to consult with counsel of their own choosing with respect to all of the financial, tax and legal consequences of participating in this Plan, including in particular the effects of participation of any community property or other interest which the Employee's spouse may have in the Compensation deferred under this Plan.

17.8 Arbitration. Any claim or controversy between the parties which the parties are unable to resolve themselves, including any claim arising out of a Participant's employment or the termination of that employment, and including any claim arising out of, connected with, or related to the formation, interpretation, performance or breach of any provision of this Plan, and any claim or dispute as to whether a claim is subject to arbitration, shall be submitted to and resolved exclusively by expedited arbitration by a single arbitrator in accordance with the following procedures:

(a) In the event of a claim or controversy subject to this arbitration provision, the complaining party shall promptly send written notice to the other party identifying the matter in dispute and the proposed remedy. Following the giving of such notice, the parties shall meet and attempt in good faith to resolve the matter. In the event the parties are unable to resolve the matter within 21 days, the parties shall meet and attempt in good faith to select a single arbitrator acceptable to both parties. If a single arbitrator is not selected by mutual consent within 10 business days following the giving of the written notice of dispute, an arbitrator shall be selected from a list of nine persons each of whom shall be an attorney who is either engaged in the active practice of law or a recognized arbitrator and who, in either event, is experienced in serving as an arbitrator in disputes between employers and employees, which list shall be provided by the main office of the American Arbitration Association ("AAA") located in Marin County, California, or the nearest office of the Federal Mediation and Conciliation Service. If, within three business days of the parties' receipt of such list, the parties are unable to agree upon an arbitrator from the list, then the parties shall each strike names alternatively from the list, with the first to strike being determined by the flip of a coin. After each party has had four strikes, the remaining name on the list shall be the arbitrator. If such person is unable to serve for any reason, the parties shall repeat this process until an arbitrator is selected.

(b) Unless the parties agree otherwise, within 60 days of the selection of the arbitrator, a hearing shall be conducted before such arbitrator at a time and a place in Marin County agreed upon by the parties. In the event the parties are unable to agree upon the time or place of the arbitration, the time and place within Marin County shall be designated by the arbitrator after consultation with the parties. Within 30 days of the conclusion of the arbitration hearing, the arbitrator shall issue an award, accompanied by a written decision explaining the basis for the arbitrator's award.

(c) In any arbitration hereunder, the Company shall pay all administrative fees of the arbitration and all fees of the arbitrator, except that the Participant or Beneficiary may, if he or she wishes, pay up to one-half of those amounts. Each party shall pay its own attorneys' fees, costs, and expenses, unless the arbitrator orders otherwise. The prevailing party in such arbitration, as determined by the arbitrator, and in any enforcement or

other court proceedings, shall be entitled, to the extent permitted by law, to reimbursement from the other party for all of the prevailing party's costs (including but not limited to the arbitrator's compensation), expenses, and attorneys' fees. The arbitrator shall have no authority to add to or to modify this Plan, shall apply all applicable law, and shall have no lesser and no greater remedial authority than would a court of law resolving the same claim or controversy. The arbitrator shall, upon an appropriate motion, dismiss any claim without an evidentiary hearing if the party bringing the motion establishes that it would be entitled to summary judgment if the matter had been pursued in court litigation. The parties shall be entitled to reasonable discovery subject to the discretion of the arbitrator.

(d) The decision of the arbitrator shall be final, binding, and non-appealable, and may be enforced as a final judgment in any court of competent jurisdiction.

(e) This arbitration provision of the Plan shall extend to claims against any parent, subsidiary, or affiliate of each party, and, when acting within such capacity, any officer, director, shareholder, Participant, Beneficiary, or agent of each party, or of any of the above, and shall apply as well to claims arising out of state and federal statutes and local ordinances as

well as to claims arising under the common law or under this Plan.

(f) Notwithstanding the foregoing, and unless otherwise agreed between the parties, either party may, in an appropriate matter, apply to a court for provisional relief, including a temporary restraining order or preliminary injunction, on the ground that the arbitration award to which the applicant may be entitled may be rendered ineffectual without provisional relief.

(g) Any arbitration hereunder shall be conducted in accordance with the employee benefit plan claims rules and procedures of the AAA then in effect; provided, however, that (i) all evidence presented to the arbitrator shall be in strict conformity with the legal rules of evidence, and (ii) in the event of any inconsistency between the employee benefit plan claim rules and procedures of the AAA and the terms of this Plan, the terms of this Plan shall prevail.

(h) If any of the provisions of this Section 17.8 are determined to be unlawful or otherwise unenforceable, in whole or in part, such determination shall not affect the validity of the remainder of this Section 17.8, and this Section 17.8 shall be reformed to the extent necessary to carry out its provisions to the greatest extent possible and to insure that the resolution of all conflicts between the parties, including those arising out of statutory claims, shall be resolved by neutral, binding arbitration. If a court should find that the provisions of this Section 17.8 are not absolutely binding, then the parties intend any arbitration decision and award to be fully admissible in evidence in any subsequent action, given great weight by any finder of fact, and treated as determinative to the maximum extent permitted by law.

(i) Arbitration of a Disability claim under this Section 17.8 shall (i) be considered one of the two levels of mandatory appeals permitted under Department of Labor Regulation Section 2560.503-1 and (ii) shall not preclude the claimant from challenging the decision of the arbitrator under Section 502(a) of ERISA.

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17.9 Performance Based Compensation. It is intended that all Deferrals that would have qualified as performance based compensation for purposes of Section 162(m) of the Code if paid when originally due (without regard to the Deferral Election), and all earnings on such Deferrals that are paid under this Plan, qualify as performance based compensation under Section 162(m) of the Code when and as actually paid in accordance with this Plan.

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REDWOOD TRUST, INC.

EXECUTIVE DEFERRED COMPENSATION PLAN

DEFERRAL ELECTION (PAGE 1 OF 4)

1. I acknowledge that the terms and conditions of the Redwood Trust, Inc. EXECUTIVE DEFERRED COMPENSATION PLAN have been explained to me, including the tax consequences of my decision to participate in the Plan. I understand that no ruling or determination letter has been obtained from the Internal Revenue Service that guarantees the deferral of income taxes on amounts deferred under the Plan.
2. I agree to defer a portion of my Compensation (as defined in the Plan) and to have that income distributed to me at a later date pursuant to the terms and conditions of the Plan, which is incorporated by reference, in its entirety, in this Deferral Election Form.
3. I understand that this Deferral Election Form is not an employment agreement, does not guarantee that I will receive any predetermined amount of compensation, and does not guarantee that I will receive any bonus, or incentive compensation.
4. I understand that any Compensation I defer will be held as an asset of Redwood Trust, Inc., and will remain subject to the claims of the general creditors of Redwood Trust, Inc. I understand that I could lose all amounts deferred and I accept that risk.

ELECTION TO DEFER COMPENSATION

I hereby elect to defer the following amount(s):

_____ % and/or \$ _____ of my salary paid in calendar year 20___. (Such deferrals will be made in equal installments throughout the year on regular pay dates unless a separate schedule is provided as part of this form and attached hereto.)

_____ % and/or \$ _____ of my bonus earned in calendar year 20__ and scheduled to be paid in the year thereafter.

_____ % and/or \$ _____ of my director's retainer paid in calendar year 20__.

_____ % and/or \$ _____ of my director's fees paid in the ____ calendar quarter(s) __ of year 20__.

_____ % and/or \$ _____ of my Cash DER's paid in ____ calendar quarter(s) of year 20__.

_____ % and/or \$ _____ of other Compensation eligible for deferral as described in an attachment hereto.

_____ shares of stock representing gain resulting from a stock-for-stock exercise of stock options. (For this election, you must also complete the "Election to Defer Stock Option Gains" form)

REDWOOD TRUST, INC.

EXECUTIVE DEFERRED COMPENSATION PLAN

DEFERRAL ELECTION (PAGE 2 OF 4)

I understand that I may discontinue deferral of future Compensation at any time during the Plan Year. I also understand that if I discontinue deferral of future Compensation during the year, I cannot restart deferral until the beginning of the succeeding calendar year or quarter, as applicable. The foregoing election is voluntarily made by me after reviewing the terms of the Plan and with knowledge that this Deferral Election is irrevocable until changed in accordance with the terms of the Plan.

I wish to have my deferrals placed in the following account as described in and subject to the terms of the Executive Deferred Compensation Plan:

___ INTEREST ACCOUNT

The Rate of Return to be applied to amounts credited to the Interest Account in accordance with the terms of the Plan for Deferrals covered by this Deferral Election has been determined by the Committee to be:

___ the default rate set forth in the Plan; or
___ the rate described in the attachment hereto.

The Interim Rate of Return to be applied to amounts distributed from the Interest Account in accordance with the terms of the Plan in respect of Deferrals covered by this Deferral Election has been determined by the Committee to be:

___ the default rate set forth in the Plan (8% per annum); or
___ the rate described in the attachment hereto.

___ STOCK EQUIVALENT ACCOUNT

(Note that if shares of Stock are being deferred through a stock-for-stock option exercise, this is the only account option available.)

I wish to receive dividend equivalents on the above deferrals placed in my Stock Equivalent Account:

___ In cash, or

___ Deferred into my Interest Account and subject to the other terms of this election.

REDWOOD TRUST, INC.

EXECUTIVE DEFERRED COMPENSATION PLAN

DEFERRAL ELECTION (PAGE 3 OF 4)

I wish to receive distributions as noted below:

___ SPECIFIED DISTRIBUTION DATE REQUEST

I wish to receive payment in respect of all deferrals made pursuant to this Deferral Election in the following form:

The earliest date for any distribution of any amount deferred is the May 1 that occurs 16 months after the end of the Plan year during which the Deferral Crediting Date for such deferred amount occurs.

- ___ (i) lump sum, payable on May 1, ___;
- ___ (ii) in annual installments beginning on May 1, ___. The number of installments will be ___ (must be at least 2 and not exceed 15). The installments will be calculated in accordance with the terms of the Plan unless another payout schedule is specified and attached hereto.

___ RETIREMENT DISTRIBUTION DATE REQUEST

I wish to receive payment in respect of all deferrals made pursuant to this Deferral Election in the following form:

- ___ (i) lump sum, payable as soon as practicable following my Retirement from the Company;
- ___ (ii) lump sum, payable on the first May 1 following my Retirement from the Company;
- ___ (iii) in annual installments beginning on the first May 1 following my Retirement from the Company. The number of installments will be ___ (must be at least 2 and not exceed 15). The installments will be calculated in accordance with the terms of the Plan unless another payout schedule is specified and attached hereto.

___ EARLIER OF SPECIFIED DISTRIBUTION DATE REQUEST OR RETIREMENT DISTRIBUTION DATE REQUEST

The method of payment will be as marked above for the earlier to occur of such requests.

REDWOOD TRUST, INC.

EXECUTIVE DEFERRED COMPENSATION PLAN

DEFERRAL ELECTION (PAGE 4 OF 4)

___ VESTING REQUIREMENTS OR OTHER CONDITIONS ON DISTRIBUTIONS

Any vesting requirements or other conditions established by the Committee that must be satisfied prior to any distribution in respect of deferrals made pursuant to this Deferral Election are attached hereto.

THIS DEFERRAL ELECTION IS EXECUTED AND AGREED:

-----	(Election Date)
(Signature)	(Date)
-----	-----
(Print Name)	(Social Security Number)

Agreed:
 Redwood Trust, Inc.
 Name: _____
 Title: _____
 Date: _____

REDWOOD TRUST, INC.

EXECUTIVE DEFERRED COMPENSATION PLAN

BENEFICIARY DESIGNATION

I. _____ (Insert Employee's/Director's name)

II. The above-named Participant's Beneficiary under the EXECUTIVE DEFERRED COMPENSATION PLAN is set forth below:

Primary Beneficiary(ies): _____
 Relationship: _____
 Address: _____
 Social Security Number: _____
 Contingent Beneficiary(ies): _____

Agreed:

Redwood Trust, Inc.

Name: _____

Title: _____

Date: _____

REDWOOD TRUST, INC.

EXECUTIVE DEFERRED COMPENSATION PLAN

INVESTMENT CHANGE ELECTION

CHANGE IN INVESTMENT OPTION ON DEFERRALS

I wish to change the investment option previously set forth under my Deferral Election dated _____, 2_____. I understand this is a one-time, irrevocable change to that Deferral Election. All other terms of that Deferral Election remain in effect. I now opt:

- (i) to direct ___% of all future deferrals under that Deferral Election to the Interest Account and ___% to the Stock Equivalent Account,
- (ii) to direct \$_____, or ___% of my existing deferrals under that Deferral Election that are currently invested in my Interest Account into the Stock Equivalent Account effective on the date specified in the Plan as set forth below.

THIS INVESTMENT CHANGE ELECTION IS EXECUTED AND AGREED:

-----	-----	(Election Date)
(Signature)	(Date)	
-----	-----	
(Print Name)	(Social Security Number)	

Agreed:

Redwood Trust, Inc.

Name: _____

Title: _____

Date: _____

REDWOOD TRUST, INC.

EXECUTIVE DEFERRED COMPENSATION PLAN

ELECTION TO DEFER STOCK OPTION GAINS

In accordance with the Redwood Trust, Inc. Executive Deferred Compensation Plan, I irrevocably elect to defer the gain from the exercise of the stock options listed in the table below to the extent therein indicated. In making this election, I understand that:

- o These options may not be exercised before six months have passed since the date of this election.
- o The exercise price of these options must be paid to the Company through deemed delivery of shares of the Company's common stock that I already own using the attestation method.
- o The shares used for payment must have been owned by me for more than six months and must not have been used for another stock option exercise within the past six months or acquired pursuant to another compensation plan within the past 12 months.
- o Upon exercise of any of these options, my Stock Equivalent Account under the Plan will be credited with a number of stock equivalent units equal to the number of gain shares being deferred.
- o I understand that dividend equivalents will be paid on my stock equivalent

REDWOOD TRUST, INC.
COMPUTATION OF PER SHARE EARNINGS

<TABLE>
<CAPTION>

	Three Months Ended June 30, 2002 -----	Six Months Ended June 30, 2002 -----
	<C>	<C>
BASIC:		
Average common shares outstanding	15,228,258	14,447,687
	-----	-----
Total	15,228,258	14,447,687
	=====	=====
Net Income	\$13,802,248	\$25,021,041
	=====	=====
Per Share Amount	\$ 0.91	\$ 1.73
	=====	=====
DILUTED:		
Average common shares outstanding	15,228,258	14,447,687
Net effect of dilutive stock options outstanding during the period -- based on the treasury stock method	518,790	472,366
	-----	-----
Total	15,747,048	14,920,053
	=====	=====
Net Income	\$13,802,248	\$25,021,041
	=====	=====
Per Share Amount	\$ 0.88	\$ 1.68
	=====	=====

</TABLE>

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Redwood Trust, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, George E. Bull III, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ George E. Bull III

George E. Bull
Chief Executive Officer
August 14, 2002

This certification is made solely for purpose of 18 U.S.C. Section 1350, subject to the knowledge standard contained therein, and not for any other purpose.

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Redwood Trust, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Harold F. Zagunis, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Harold F. Zagunis

Harold F. Zagunis
Chief Financial Officer
August 14, 2002

This certification is made solely for purpose of 18 U.S.C. Section 1350, subject to the knowledge standard contained therein, and not for any other purpose.