UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[X] **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended: December 31, 2003

OR

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

For the transition period from to

Commission file number: 1-13759

REDWOOD TRUST, INC.

(Exact name of Registrant as specified in its Charter)

Maryland (State or other jurisdiction of incorporation or organization)	**68-0329422** (I.R.S. Employer Identification No.)
One Belvedere Place, Suite 300 **Mill Valley, California** (Address of principal executive offices)	**94941** (Zip Code)

(415) 389-7373
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:	Name of Exchange on Which Registered:
Common Stock, par value $0.01 per share (Title of Class)	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act:
None

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [X] No [ ]

At June 30, 2003 the aggregate market value of the voting stock held by non-affiliates of the Registrant was $711,230,363.

The number of shares of the Registrant's Common Stock outstanding on March 4, 2004 was 19,439,091.

Documents Incorporated by Reference

Portions of the Registrant's definitive Proxy Statement issued in connection with the 2004 Annual Meeting of Stockholders are incorporated by reference into Part III.

REDWOOD TRUST, INC.
2003 FORM 10-K ANNUAL REPORT

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PART I

Item 1. BUSINESS

SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS

Statutory “safe harbor” applies to “forward-looking” statements under the Private Securities Litigation Reform Act of 1995 within the meaning of the Securities Act of 1933 and of the Securities Exchange Act of 1934. Forward-looking statements inherently involve certain risks and uncertainties. Any matter discussed in this Form 10-K that is not historical fact or contains estimates may constitute a forward-looking statement. Although we continuously update and revise our estimates, it is not practical to publish all such revisions and, thus no one should assume that any estimates or the results or trends projected in or contemplated by any forward-looking statements would prove to be accurate in the future. Forward-looking statements can be identified by the presence of words such as “may”, “will”, “believe”, “expect”, “anticipate”, “estimate”, “intend”, “plan”, or similar words and terminology. Actual results and the timing of certain events could differ materially from those addressed in forward-looking statements due to a number of factors, including, among other things: changes in interest rates and market values; changes in prepayment rates; general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the level of liquidity in the capital markets as it affects our ability to finance our real estate asset portfolio; and other factors not presently identified. For a discussion of risk factors, readers should review the section of this Form 10-K entitled “Risk Factors”. This Form 10-K 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.

REDWOOD TRUST

Redwood Trust is a financial institution that invests in real estate loans. Our primary market is high-quality jumbo residential mortgages. Our primary goal is to generate steady income and dividends for our shareholders.

We invest in high-quality residential real estate loans originated throughout the United States. We also invest in real estate loan securities created from these loans. Our investments consist of high-quality jumbo residential real estate loans, securities backed by jumbo residential real estate loans, various other diverse residential and commercial real estate loan securities, and commercial real estate loans. The interest income we earn from these investments is derived from monthly loan payments made by homeowners and property owners. This income covers our expenses, which are primarily borrowing costs and operating expenses, and our dividend distributions. Our status as a Real Estate Investment Trust (REIT) allows us to avoid paying certain income taxes by distributing the majority of our REIT taxable income to our shareholders in the form of dividends.

We acquire high-quality jumbo residential real estate loans from various large mortgage origination companies throughout the United States. Jumbo real estate loans have mortgage balances that exceed the conforming loan limits imposed upon Fannie Mae and Freddie Mac, two large U.S. government-sponsored residential real estate loan investment companies. Most of our loans have balances between $350,000 and $750,000 with an average balance over $430,000. We also acquire securities representing subordinated interests in pools of high-quality residential real estate loans. We refer to these securities as residential loan credit-enhancement securities as they effectively enhance the credit of more senior securities within a securitized loan pool. Our returns on credit-enhancement securities are driven primarily by the credit performance of the underlying real estate loans.

We fund the majority of our real estate loan investments through securitizations, where we issue non-recourse long-term debt in the form of securities, using the real estate loan investments as collateral. This is an efficient form of long-term financing that helps us maximize our return on equity while limiting our credit and liquidity risk.

For each of our securitizations, specific real estate loan investments are transferred to a securitization trust formed as a bankruptcy-remote special purpose entity that is wholly owned by Redwood Trust. The securitization trust issues multiple classes of securities with varying maturities and coupons. We sell most of these securities but typically retain a portion of the subordinated securities from each securitization for our own investment portfolio. There is no gain or loss generated from these securitizations. We account for these transactions as financings — not sales — and therefore we include all of the assets and debt associated with each securitization on our consolidated balance sheet.

Redwood Trust, Inc., our parent company, is organized as a REIT. Our REIT status allows us to avoid paying certain income taxes by distributing the majority of REIT taxable income, as stipulated by the IRS, to our shareholders in the form of dividends. The REIT rules allow us to temporarily defer distributions of REIT taxable income. We may also permanently retain a portion of our REIT taxable income as well as retain all income earned by our taxable subsidiaries. We are subject to income taxes on retained taxable income. We may defer dividend distributions and retain income from time to time to help us maintain and grow our dividend-paying potential.

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

At March 4, 2004, Redwood Trust had 19,439,091 outstanding shares of common stock, traded on the New York Stock Exchange, Symbol “RWT”.

Our website address is www.redwoodtrust.com. We make available free of charge on our website our annual report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K (if applicable), amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, and certain “supplemental financial data” as soon as reasonably practicable after we electronically file such material with, or furnish it to the SEC. None of the information on or hyperlinked from our website is incorporated into this Annual Report on Form 10-K.

The preceding summary highlights information contained elsewhere in this Form 10-K. You should carefully read this Form 10-K with particular attention to our Consolidated Financial Statements and the Notes to the Consolidated Financial Statements beginning on Page F-1. In addition, for a description of important risk factors, among others, that could affect our actual results and could cause our actual consolidated results to differ materially from those expressed in any forward-looking statements made by us see “Risk Factors” commencing on page 13 of this Form 10-K.

COMPANY BUSINESS AND STRATEGY

General

Our business model and principal strategy are based on our belief that an efficiently structured financial company can achieve consistent growth and profitability though disciplined investing in high-quality jumbo real estate loans — those loans outside the reach of the big U.S. government-sponsored home mortgage investors. Our primary goal is to generate steady income and dividends for our shareholders.

Our Industry

There are approximately $7.1 trillion of residential real estate loans outstanding in the United States. The amount outstanding has grown at an average rate of 9% per year for approximately 20 years as home ownership and housing values have generally increased. New originations of residential real estate loans have ranged from $1.0 trillion to $3.8 trillion per year over the last five years. Originations generally increase in years when refinancing activity is stronger due to declines in long-term interest and mortgage rates.

The U.S. government-sponsored residential real estate loan investment companies, Fannie Mae and Freddie Mac, are prohibited from owning and credit-enhancing certain real estate loans with balances over limits (the limit for single-family mortgage loans originated within the continental United States is currently $333,700). Loans with balances larger than this limit are commonly referred to as jumbo loans. We estimate that over the past five years, new originations of jumbo residential real estate loans have ranged between $200 billion and $700 billion per year making up between 18% and 22% of total new residential loan originations. We believe that total outstanding jumbo residential real estate loans total over $1.4 trillion. We also believe that the outstanding balance of jumbo residential real estate loans will continue to grow at the same rate as the residential loan market as a whole (4%-12% per year).

Each year the amount of jumbo loans that are available for sale consists of new originations plus seasoned loans that are sold into the secondary mortgage market by financial institutions from their portfolio, less loans that are retained by originators for their own portfolios. The amount of jumbo loans for sale each year depends on the economic conditions and other factors that determine the level of new loan originations and the relative attractiveness to financial institutions of selling versus retaining loans.

Historically, jumbo residential real estate loans that are available for sale have been purchased by financial institutions such as banks and thrifts that want to increase their loan portfolios to a size that is bigger than they can achieve through retaining all their own loan production. These institutions fund their loan investment activities with deposits and other borrowings. Increasingly since the mid-1980s, jumbo residential real estate loans have been funded through the creation and sale of mortgage-backed securities to the capital markets. We estimate that the share of jumbo residential real estate loans outstanding that have been securitized has been increasing steadily from approximately 10% in 1990 to over 50% in 2003. We believe that loan securitization has become the financing method of choice in the jumbo loan market because securitization is generally a more efficient form of funding than deposits or other borrowings.

Jumbo residential real estate loan securitizations may consist of seasoned loans or newly originated loans. Seasoned loan securitizations generally contain loans that are being sold from the retained mortgage portfolios of the larger banks and thrifts. Securitizations of new originations generally contain loans sold by the larger originators of jumbo mortgage loans or by conduits. Conduits acquire individual loans or small loan portfolios in order to aggregate loan pools for securitization.

Substantially all of the demand for mortgage-backed securities comes from investors that desire to hold the cash flows of a residential real estate loan but are not able or willing to build the operations necessary to manage the credit risk of loans. These investors demand that mortgage-backed securities be rated investment-grade by the credit rating agencies. In order to create investment-grade mortgage-backed securities from a pool of residential real estate loans, credit enhancement for those loans must be provided and someone other than the investment-grade security buyer must assume the credit risk.

In a securitization, a pool of residential real estate loans can be credit enhanced through a number of different methods. The senior/subordinated structure is currently the most prevalent method for credit enhancement of jumbo residential real estate loans. This structure establishes a set of senior security interests in the pool of real estate loans and a set of subordinated (junior) security interests in the pool. The set of subordinated interests is acquired by one or more entities that provide credit enhancement to the underlying real estate loans. Credit losses in the loan pool reduce the principal of the subordinated interests first, thus providing some credit protection to the senior securities that allows them to be rated investment grade. Other forms of credit enhancement, such as pool insurance provided by mortgage insurance companies, bond insurance provided by bond insurance companies, and corporate guarantees are often less efficient than the senior/subordinated structure due to regulation and rating agency requirements, among other factors.

Credit enhancers of jumbo residential real estate loan securitizations profit from cash flows generated from the ownership of the subordinated credit-enhancement interests. The amount and timing of credit losses in the underlying loan pools affect the yields generated by these assets. These interests are generally purchased at a discount to the principal value of the interest, and much of the potential return to the subordinated investor is generated through the ultimate return of the principal that remains after realized credit losses are deducted.

The business of enabling the securitization of jumbo residential real estate loans by assuming the credit risk on the loans is highly fragmented. Credit enhancers of jumbo residential loan securitizations include banks and thrifts (generally credit-enhancing their own loan originations), insurance companies, Wall Street broker-dealers, hedge funds, private investment firms, mortgage REITs, and others.

The liquidity crisis in the financial markets in 1998 caused many of the participants in this market to withdraw. With reduced demand stemming from reduced competition, and increased supply as a result of increased originations and sales of seasoned loan portfolios, prices of residential credit-enhancement interests declined and the acquisition of these interests became more attractive. Prices further declined in 1999 as financial turmoil continued and many financial institutions reorganized themselves to focus on other businesses.

From 1998 through 2002, the prices of assets and the margins available in the jumbo residential credit-enhancement business were generally attractive. In 2003, while the supply of credit-enhancement securities generally increased as a result of an increase in jumbo real estate loan securitizations, there was a general increase in competition, demand, and prices in this market. We believe that we will continue to experience increased competition and that reduced supply is likely in the next few years which will continue to affect prices.

Our Company

Over the past nine years, we have built a company that allows us to compete effectively in the business of investing in high-quality jumbo residential real estate loans in the United States. The key aspects of our business model are as follows:

Focus. We target the ownership and credit enhancement of jumbo residential real estate loans as our primary business. Our specialty is acquiring jumbo residential real estate loans and funding these acquisitions through securitizations. We also specialize in acquiring credit-enhancement securities that facilitate the securitizations of others. We believe securitizations are an efficient form of financing jumbo residential real estate loans and have advantages over the typical funding methods used by depository institutions such as banks and thrifts. By focusing on funding our investments via securitization, we believe our long-term growth opportunities will continue to be attractive. We believe that opportunities will be particularly attractive if an increasing share of jumbo residential real estate loans continues to be securitized and if the jumbo residential real estate loan market as a whole continues to grow at historical rates.

Emphasis on long-term asset portfolio. Through our operations, we seek to structure and build a unique portfolio of valuable real estate loan assets. For our residential loan portfolios, we seek to structure long-term assets with expected average lives of five to ten years. The long-term nature of these assets helps to reduce reinvestment risk and generally provides us with more stable, proprietary cash flows that help support our goal of maintaining steady dividends over time.

Specialized expertise and scalable operations. We have developed all of the specialized expertise necessary to efficiently and economically invest in and credit enhance jumbo residential real estate loans. Our accumulated market knowledge, relationships with mortgage originators and others, sophisticated risk-adjusted capital policies, strict underwriting procedures, and successful experience with shifting financial market conditions allow us to acquire and securitize real estate loans and effectively manage the risks inherent with those businesses. We build and maintain relationships with large mortgage originators, banks that are likely to sell real estate loan portfolios, Wall Street firms that broker real estate loans and securities, and the buyers of our bonds. We continue to develop our staff, our analytics, our models, and other capabilities that help us structure securitization transactions and cash flows, evaluate credit quality of individual loans and pools of loans, underwrite loans effectively, and monitor trends in credit quality and expected losses in our existing portfolios. We establish relationships with our servicing companies to assist with monthly surveillance, loss mitigation efforts, delinquent loan work-out strategies, and REO liquidation. Aside from collaborating with our servicers on these issues, we insist that specific foreclosure timelines are followed and that representations and warranties made to us by sellers are enforced. For balance sheet management, we work to project cash flows and earnings, determine capital requirements, source borrowings efficiently, preserve liquidity, and monitor and manage risks effectively.

Even as we continue to enhance our capabilities, we believe that our operations are scalable. In the long run, we do not expect our operating costs to grow at the same rate as our net interest income should we expand our capital base and our portfolios. Thus, other factors being equal, growth in capital could be materially accretive to earnings and dividends per share.

Competitive advantage of our corporate structure. As a REIT, we pay only limited income taxes, traditionally one of the largest costs of doing business. In addition, we are not subject to the extensive regulations applicable to banks, thrifts, insurance companies, and mortgage banking companies; nor are we subject to the rules governing regulated investment companies. We believe the absence of business-restrictive regulations in our market sector is a competitive advantage. The regulations applicable to certain financial companies can cause capital inefficiencies and higher operating costs for certain of our competitors. Our structure enables us to acquire attractive investments that are not feasible or practical for other financial companies.

Flexibility in real estate loan portfolio orientation. We are open to other areas of opportunity within real estate finance and related fields that may compliment and benefit our core business activity of investing in jumbo residential real estate loans. In addition to our jumbo residential loan operations, we currently invest in commercial real estate loans and in securities collateralized by diverse types of residential and commercial real estate loans. Depending on the relative attractiveness of the opportunities in these or new product lines, we may increase or decrease the size of and capital allocation to these portfolios over time.

We also generally look for investment opportunities that fit our value orientation, that take advantage of the structural advantages of our balance sheet, that do not put us in competition with Fannie Mae and Freddie Mac, and that allow us to develop an advantage over many of our competitors.

Our Strategy

Our objective is to produce attractive earnings and dividend growth for shareholders, primarily through investing in high-quality jumbo residential real estate loans and other real estate loans and securities.

The key aspects of our strategy are as follows:

Preserve portfolio quality. In our experience, the highest long-term risk-adjusted returns come from investing in the highest quality loans. For this reason, we have focused on acquiring “A quality” or “prime quality” jumbo residential real estate loans. Within the prime real estate loan category, there are degrees of quality: “A”, “Alt-A”, and “A minus.” As compared to the market as a whole, we believe our portfolio is generally concentrated in the top quality end of the “A” residential real estate loan category.

We generally acquire residential real estate loans from large, high-quality, national mortgage origination companies. We also have the top quality servicing companies processing our loan payments and assisting with loss mitigation. While we may acquire or credit-enhance loans that are less than “A” quality, we currently intend to do so only for seasoned loans of this type that may have less risk than newly-originated loans. We also may own A-minus, Alt-A, and sub-prime residential real estate loan securities that, for the most part, are rated investment-grade because they are credit enhanced in some form by others, which mitigates our risk of credit-loss from these securities.

Maintain geographic diversity. With respect to geography, our jumbo residential real estate loan portfolio is approximately as diverse as the U.S. jumbo residential real estate loan market as a whole. We finance loans in all 50 states. With the exception of California, no one state generally represents more than 5% of our portfolio. Our exposure to California loans is approximately 50%, about the same percentage as the total jumbo residential real estate loans outstanding in the United States. We have less than 1% of our jumbo loans are in any one zip code in the United States.

Match-fund effectively. In the course of our business, we do not generally seek to put ourselves in a position where the anticipation of specific interest rates or loan prepayment rates is material to meeting our long-term goals. Accordingly, we generally attempt to match the interest rate, prepayment rate, and cash flow characteristics of our on-balance sheet assets to our liabilities. Currently, our assets are funded with debt that generally matches the interest rate and prepayment characteristics of the assets (i.e., our adjustable-rate assets are funded with floating rate debt, fixed-rate assets with fixed-rate debt, etc.). Any amount of unhedged or unmatched hybrid and fixed-rate assets we own generally does not materially exceed our equity base. We use interest rate agreements to help us achieve our desired asset/liability mix and we anticipate continuing to use these interest rate agreements in the future. Although our assets and liabilities are effectively match-funded, some variation in earnings may still result from changes in short-term interest rates.

Manage capital levels. We manage our capital levels, and thus our access to borrowings and liquidity, through sophisticated risk-adjusted capital policies supervised by our senior executives. We believe these conservative and well-developed guidelines are an important tool that helps us achieve our goals and mitigate the risks of our business. We seek to continually improve the effective use of our capital without changing our underlying goals and disciplines. Through these policies, we effectively assign a capital adequacy guideline amount, expressed as an equity-to-assets ratio, to each of our assets. In most circumstances in which our actual capital levels decreased below our capital adequacy guideline amount, we would expect to cease the acquisition of new assets until capital guideline levels were restored through loan prepayments, asset sales, securitization transactions, capital raising, or other means.

Our current plan is to use long-term securitized non-recourse debt to fund our assets and restrict our use of short-term recourse debt to the temporary funding of assets under accumulation for securitization. To the extent that we do have assets funded with short-term recourse debt that is subject to margin calls, our capital requirement guidelines will fluctuate over time, based on changes in the short-term funded 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. We typically fund our residential credit-enhancement securities and our retained interests from our securitizations with equity. The size of our retained interest in our securitizations relative to the amount of assets underlying that securitization generally depends on the determination of the credit rating agencies with respect to the amount of credit-enhancement necessary to create investment-grade bonds to be issued from the securitization. Retained interests generally range from 0.5% to 2.0% of high-quality residential real estate loans, from 1% to 7% of re-securitized real estate loan securities, and from 5% to 30% of commercial real estate loans.

Pursue growth. We are pursuing a long-term growth strategy, seeking to increase the amount of equity capital we have employed in our business of investing in real estate loans. As we increase our size, we believe we will be able to strengthen our relationships with our customers from whom we buy assets, thus potentially giving us certain pricing, cost, and other competitive advantages. As we increase the size of our capital base, we believe that we may benefit from improved operating expense ratios, lower borrowing expenses, improved capital efficiencies, and related factors that may improve earnings and dividends per share. In order to continue to grow, we have been expanding our capabilities and financing arrangements to allow us to increase our investment in commercial real estate loans and diverse residential and commercial real estate loan securities. We believe our new product areas we pursue will provide us with diversification of both risk and opportunity.

OUR REAL ESTATE LOAN ASSETS

We have four basic classifications of real estate loan investments: residential real estate loans, residential real estate loan credit-enhancement securities, commercial real estate loans, and securities portfolio (consisting of diverse residential and commercial real estate securities, primarily investment-grade). Each of these investment types is a component of our single business segment of investing in real estate loans. Our current intention is to focus on investing in and managing these four existing asset classifications. We manage our real estate loan investments as a single business segment, with common staff and management, intermingled financing arrangements, and flexible capital allocations.

Residential Loan Real Estate Loans

We acquire high-quality jumbo residential real estate loans and hold them as a long-term investment. We generally fund these acquisitions with our equity and non-recourse, long-term securitized debt that closely matches the interest rate, prepayment, and maturity characteristics of the loans. We show on our balance sheet both the underlying residential real estate loans that we have securitized and the debt that we issue to fund the loans.

The net interest income we earn from these assets equals the interest income we earn on our loans, less expenses related to (1) interest (including issuance fees) and hedging costs on borrowed funds, (2) amortization of premium paid in excess of the principal upon acquisition of the loans, and (3) credit provision incurred to provide for the appropriate credit reserves for credit losses.

The process of adding to our residential real estate loan portfolio commences when we underwrite and acquire residential real estate loans from sellers. We generally seek to quickly build a portfolio large enough, at least $200 million, to support an efficient issuance of long-term debt via securitization. We source our loan acquisitions primarily from large, well-established mortgage originators and the larger banks and thrifts.

We are always seeking bulk purchases of residential whole loan portfolios that meet our acquisition criteria and that are priced attractively relative to our long-term debt issuance levels. In addition, we acquire new loans on a continuous or “flow” basis from originators that have loan programs that meet our desired quality and loan type standards.

We initially fund our residential loan acquisitions with short-term debt. When we are ready to issue long-term debt, we contribute these loans to one of our wholly owned, special purpose entity financing subsidiaries (Sequoia Mortgage Funding Corporation or Sequoia Residential Funding, Inc., or “Sequoia”). Sequoia, through a trust, then issues mostly investment grade rated long-term debt that generally matches the interest rate, prepayment, and maturity characteristics of the loans and remits the proceeds of this offering back to us. Our net investment equals our basis in the loans less the net proceeds that we received from the sale of long-term debt. The amount of equity that we invest in these trusts to support our long-term debt issuance is determined by the credit rating agencies, based on their review of the loans and the structure of the transaction.

We plan to accumulate more high-quality jumbo residential loans when loans are available on attractive terms relative to our anticipated costs of issuing long-term debt. We currently focus on only adjustable-rate mortgage loans, but may also invest in hybrid or fixed-rate loans.

Residential Loan Credit-Enhanced Securities

In addition to investing in residential real estate loans, we also credit enhance pools of high-quality jumbo residential loans that have been securitized by others. We do this by acquiring subordinated securities in third-party securitizations. These credit-enhancement securities bear the bulk of the potential credit risk for the securitized pool of loans in order for the more senior securitized interests to qualify for investment grade ratings for efficient sale into the capital markets.

Generally, we acquire credit-enhancement securities from the top twenty high-quality national mortgage origination firms and certain other smaller firms that specialize in high-quality jumbo residential real estate loan originations. We also work with large banks that are sellers of seasoned portfolios of high-quality jumbo residential real estate loans. We either work directly with these customers or we work in conjunction with an investment bank on these transactions. Our credit-enhancement securities are backed by fixed rate, hybrid, and adjustable-rate residential real estate loans.

The principal value of the credit-enhancement securities in any rated senior/subordinated securitization is determined by the credit rating agencies: Moody’s Investors Service, Standard & Poor’s Rating Services, and Fitch Ratings. These credit agencies examine each pool of residential real estate loans in detail. Based on their review of individual loan characteristics, they determine the credit-enhancement levels necessary to award investment grade ratings to the bulk of the securities formed from these loans.

Our actual investment, and our risk, is less than the principal value of our credit-enhancement securities since we acquire these interests at a discount to principal value. A portion of this discount we designate as our credit protection for future losses; the remainder we amortize into income over time.

Our first defense against credit loss is the quality of the residential real estate loans we acquire or otherwise credit enhance. Our loans are generally in the high-quality range for loan factors such as loan-to-value ratios, debt-to-income ratios, credit quality of the borrower, and completeness of documentation.

Our loans are secured by the borrowers' homes. Compared to most corporate and consumer loans, the residential real estate loans that we credit enhance have a much lower loss frequency and a much lower loss severity (the severity is the percentage of the loan principal and accrued interest that we lose upon default).

Our exposure to credit risks of the residential real estate loans that we credit enhance is further limited in a number of respects as follows:

Risk tranching. A typical residential real estate loan securitization has three credit-enhancement interests: a "first loss" security, a "second loss" security, and a "third loss" security. Our first loss security investments are directly exposed to the risk of principal loss on any loan in the underlying loan pool that may default. Our second loss securities are exposed to credit loss if cumulative pool losses exceed the remaining principal value of the first loss security. Our third loss securities are exposed to loss if cumulative pool losses exceed the remaining principal value of both the first and second loss security. Thus, not all our investments in credit-enhancement securities are immediately exposed to loss, and to the extent a third-party owns a first loss security or another security that is junior to the security we own, we benefit from the credit-enhancement provided by others.

Limited maximum loss. Our potential credit exposure to the residential real estate loans that we credit enhance is limited to our investment in the credit-enhancement securities that we acquire.

Credit protection established at acquisition. We acquire credit-enhancement interests at a discount to their principal value. We book a portion of this discount as credit protection against future credit losses. For many economic environments, we believe that this protection should be large enough to absorb future losses. We establish the amount of our credit protection at acquisition and adjust it over time following a review of the underlying collateral, economic conditions, and other factors. If future credit results are favorable, we may not need all of the amounts designated as credit protection. In such event, we may then redesignate some of these balances as discount to be amortized into income over time. If future credit results are worse than previously anticipated, we may need to increase the amount of designated credit protection which could result in an immediate negative impact on earnings.

Mortgage insurance. A small portion of our credit-enhanced portfolio consists of residential real estate loans with initial loan-to-value, or LTV, ratios in excess of 80%. For the vast majority of these higher LTV ratio loans, we benefit from primary mortgage insurance provided on our behalf by the mortgage insurance companies or from pledged asset accounts. Thus, for what would otherwise be our most risky mortgage loans, we have passed much of the risk on to third parties and our effective loan-to-value ratios on these loans are lower than 80%.

Representations and warranties. As the credit enhancer of a residential real estate loan securitization, we benefit from representations and warranties received from the sellers of the loans. In limited circumstances, the sellers are obligated to repurchase delinquent loans from our credit-enhanced pools, thus reducing our potential exposure.

We believe that the outlook for investing in new jumbo residential real estate credit-enhancement securities is reasonably favorable. A reasonable supply of investment opportunities is expected to continue even if securitization volume drops as a result of higher interest rates leading to lower new loan originations and as a result of increased demand for whole loans from competition. Although pricing for these assets has increased in recent quarters, we expect we can continue to find investment opportunities for these securities at prices to generate attractive long-term returns. In general, we expect house prices to increase over time (thus reducing our credit risk on our loans) because the restrictions on new construction and the lack of raw land in most jumbo loan neighborhoods limit supply relative to demand.

Commercial Real Estate Loans

Our primary investment focus is on high-quality residential real estate loans. We also invest in commercial real estate loans. Starting in 1998, we originated commercial real estate loans for our portfolio. Currently, our goal is to increase the size of our commercial real estate loan portfolio through acquisition rather than origination. We finance our commercial real estate loan portfolio with equity and through selling senior loan participations. We intend to acquire commercial real estate loans, loan participations, mezzanine loans, commercial real estate loan securities, and commercial credit-enhancement securities in the future.

To date, we have had few delinquencies and losses on our investments in commercial real estate loans. A slowing economy, and factors particular to each commercial loan, could cause credit losses in the future. As this occurs, we would provide for future losses by creating a specific credit reserve on a loan-by-loan basis.

Securities Portfolio

Our securities portfolio contains the balance of all securities not considered residential credit-enhancement securities or cash-equivalents.

With regards to investing in real estate loan securities and in structuring debt issuance to fund investments in these securities, we believe we have certain advantages relative to other capital markets investors. We are an efficient company with very capable and experienced professional staff in an industry that is not burdened by over-regulation and benefits from certain REIT-related tax advantages.

Most of our securities portfolio investments are rated investment-grade (AAA to BBB); as a result, we generally do not take primary credit risk with respect to the loans underlying these securities because we benefit from credit-enhancement provided by others. We own real estate securities backed by prime residential loans, sub-prime residential loans, manufactured housing loans, and commercial real estate loans. We also own CDO debt and equity (collateralized debt obligations) that are re-securitizations of diverse real estate securities and we own corporate bonds issued by REITs that own commercial real estate properties.

We fund our securities and some of our credit-enhancement securities with equity and with long-term debt issued via our “Acacia” CDO securitization program. We currently use short-term recourse debt financing for our securities portfolio only on a temporary basis while we are accumulating securities prior to a CDO issuance.

We invest in diverse real estate loan securities for several reasons:

- Acquiring these various types of real estate securities allows us to obtain efficient non-recourse financing for our residential credit-enhancement securities. Accumulation of a diverse pool of securities, of which our residential credit-enhancement securities are a part, allows us to issue non-recourse long-term debt in the form of CDO transactions.
- Given our balance sheet characteristics, tax status, and the capabilities of our staff, we believe our investment in real estate securities can earn an attractive return on equity.
- Investing in a variety of types of real estate securities diversifies both our risks and our opportunities.
- By developing our Acacia CDO debt issuance program, involving the accumulation and re-securitization of primarily investment-grade real estate securities, we can efficiently invest in some of the investment-grade bonds of the securitizations that we credit enhance and we can efficiently retain some of the investment-grade bonds that we would otherwise issue in our securitization of our high-quality residential real estate loans. It is efficient from an operating cost perspective for us to increase the size of our investment in transactions where we are already devoting considerable resources to underwrite and assess loans and origination and servicing standards.

OUR OPERATIONS

Our portfolio management staff leads flexible interdisciplinary product management teams that work to acquire attractive real estate loan investments, issue securitized long-term debt, and increase our profitability over time. Our finance staff participates on these teams, and manages our overall balance sheet, borrowings, cash position, accounting, finance, tax, equity issuance, and investor relations.

We build and maintain relationships with mortgage originators, such as: banks that are likely to sell real estate loan portfolios; Wall Street firms that broker real estate securities; mortgage servicing companies that process payments for us and assist with loss mitigation; technology and information providers that help us conduct our business more effectively; banks and Wall Street firms that provide us credit and assist with the issuance of our long-term debt; commercial property owners and other participants in the commercial real estate loan market; and the capital markets investors that buy our issuance of securitized debt.

We evaluate, underwrite, and execute real estate asset acquisitions. Some of the factors that we take into consideration are: asset yield characteristics; liquidity; anticipated credit losses; expected prepayment rates; the cost and type of funding available for the particular asset; the amount of capital necessary to carry the particular investment in a prudent manner and to meet our internal risk-adjusted capital guidelines; the cost of any hedging that might be employed; potential market value fluctuations; contribution to our overall asset/liability objectives; potential earnings volatility in adverse scenarios; and cash flow characteristics.

We monitor and actively manage our credit risks. We work closely with our residential and commercial mortgage servicers, especially with respect to delinquent loans. While procedures for working out troubled credit situations for residential loans are relatively standardized, we still find that an intense focus on assisting and monitoring our servicers in this process yields good results. We work to enforce the representations and warranties of our sellers, forcing them to repurchase loans if there is a breach of the conditions established at purchase. If the loans that make up one of our investments start to under-perform our expectations, or if a servicer is not fully cooperative with our monitoring efforts, we may seek to sell that investment at the earliest opportunity before its market value is diminished.

Prior to acquiring a credit-enhancement security, we typically review origination processes, servicing standards, and individual loan data. In some cases, we underwrite individual loan files. Prior to acquiring whole loans for our residential real estate loan portfolio, we conduct a legal document review of the loans, review individual loan characteristics, and underwrite loans that appear to have higher risk characteristics.

We actively monitor and adjust the asset/liability characteristics of our balance sheet. We follow our internal risk-adjusted capital guidelines, seeking to make sure that we are sufficiently capitalized to hold our assets to maturity through periods of market fluctuation. We monitor our cash levels, the liquidity of our assets, the stability of our borrowings, and our projected cash flows and market values to make sure that we maintain a strong liquidity position. We generally seek to match the interest rate characteristics of our assets and liabilities. If we cannot achieve our matching objectives on-balance sheet, we use interest rate hedge agreements to adjust our overall asset/liability mix. We monitor potential earnings fluctuations and cash flow changes from prepayments. We project credit losses and cash flows from our credit sensitive assets, and reassess our credit provisions and reserves, based on information from our loss mitigation efforts, borrower credit trends, and housing price trends. We monitor the market values of our assets and liabilities by reviewing pricing from external and internal sources.

In order to accumulate loans and securities for future securitization transactions and for liquidity management purposes, we utilize short-term borrowings from a variety of counter-parties. We structure long-term debt issuance, and work with the credit rating agencies to get optimal ratings and efficient financing structures for the securitized debt we issue.

RISK FACTORS

The following is a summary of the risk factors that we currently believe are important and that could cause our results to differ from expectations. This is not an exhaustive list; other factors not listed below could be material to our results.

We assume direct credit risk in our residential real estate loan investments. Real estate loan delinquencies, defaults, and credit losses could reduce our earnings and credit losses could reduce our cash flows and access to liquidity.

In our residential real estate loan portfolio, we assume the direct credit risk of residential loans. Realized credit losses will reduce our earnings and future cash flow. We have a credit reserve for these loans and we may continue to add to this reserve in the future. There can be no assurance that our credit reserve will be sufficient to cover future losses. We may need to reduce earnings by increasing our credit reserve in the future.

As a core part of our business, we assume the credit risk of real estate loans. We do this in each of our portfolios. We may add other product lines over time that may have different types of credit risk than are described herein. We are generally not limited in the types of credit risk or other types of risk that we can undertake. As we acquire more credit-sensitive loans and securities, we increase our credit risk exposure.

Credit losses on residential real estate loans can occur for many reasons, including: poor origination practices related to fraud, faulty appraisals, documentation errors, poor underwriting, legal errors, etc.; poor servicing practices; weak economic conditions; declines in the values of homes; special hazards; earthquakes and other natural events; over-leveraging of the borrower; changes in legal protections for lenders; reduction in personal incomes; job loss; and personal events such as divorce or health problems.

If the U.S. economy or the housing market weakens, our credit losses could be increased beyond levels that we have anticipated. If we incur increased credit losses, our earnings might be reduced, and our cash flows, asset market values, and access to borrowings might be adversely affected. The amount of capital and cash reserves that we hold to help us manage credit and other risks may prove to be insufficient to protect us from earnings volatility, dividend cuts, liquidity, and solvency issues.

The way we account for credit losses differs between Generally Accepted Accounting Principles (GAAP) and tax. While we may establish a credit reserve for reporting purposes, we are not permitted for tax purposes to reduce our taxable REIT income to provide for a reserve for future credit losses. Thus, if credit losses occur in the future, taxable REIT income may be reduced relative to GAAP income. When taxable REIT income is reduced, our minimum dividend distribution requirements under the REIT tax rules are reduced. We could reduce our dividend rate in such a circumstance. Alternatively, credit losses in some assets may be capital losses for tax. Unless we had offsetting capital gains, our minimum dividend distribution requirement would not be reduced by these credit losses, but eventually our cash flow would be. This could reduce our free cash flow and liquidity.

Despite our efforts to manage our credit risk, there are many aspects of credit that we cannot control, and there can be no assurance that our quality control and loss mitigation operations will be successful in limiting future delinquencies, defaults, and losses. Our underwriting reviews may not be effective. The representations and warranties that we receive from sellers may not be enforceable. We may not receive funds that we believe are due to us from mortgage insurance companies. Although we rely on our servicers, they may not cooperate with our loss mitigation efforts, or such efforts may otherwise be ineffective. Various service providers to securitizations, such as trustees, bond insurance providers and custodians, may not perform in a manner that promotes our interests. The value of the homes collateralizing our loans may decline. The frequency of default, and the loss severity on our loans upon default, may be greater than we anticipated. Interest-only loans, negative amortization loans, loans with balances over $1 million, and loans that are partially collateralized by non-real estate assets may have special risks. Our geographical diversification may be ineffective in reducing losses. If loans become “real estate owned,” or REO, our agents or we will have to manage these properties and may not be able to sell them. Changes in consumer behavior, bankruptcy laws, and the like may exacerbate our losses.

In some states and circumstances, we have recourse against the borrower's other assets and income; but, in most cases, we may only be able to look to the value of the underlying property for any recoveries. Expanded loss mitigation efforts in the event that defaults increase could be costly. The mortgage rate on the bulk of our loans is adjustable; when short-term interest rates rise, required monthly payments from homeowners will rise and this may increase delinquencies and defaults. We expect to continue to increase the size of our residential loan portfolio, and will likely increase our balance sheet leverage with respect to these loans, thus exposing us to a greater degree to the potential risks of owning these loans.

We have credit risks in our residential loan credit-enhancement securities related to the underlying loans. Accounting for such interests requires us to make many assumptions that may not bear out.

Our total net investment in residential credit-enhancement securities includes a portion of securities that are in a first loss position with respect to the underlying loans. Upon acquisition of a credit-enhancement security, we generally expect that the entire amount of these first loss investments will be subject to credit loss, potentially even in healthy economic environments. Our ability to make an attractive return on these investments depends on how quickly these expected losses occur. If the losses occur more quickly than we anticipate, we may not recover our investment and/or our rates of return may suffer significantly.

Second loss credit-enhancement securities, which are subject to credit loss when the entire first loss investment (whether owned by us or by others) has been eliminated by credit losses, make up another portion of our net investment in credit-enhancement securities. Third loss credit-enhancement securities, or other investments that themselves enjoy various forms of material credit enhancement, make up the remainder of our net investment in credit-enhancement interests. Given our normal expectations for credit losses, we would anticipate some future losses on many of our second loss interests but do not anticipate losses on investments in the third loss or similar positions. If credit losses are greater than, or occur sooner than, expected, our expected future cash flows will be reduced and our earnings will be negatively affected. Credit losses and delinquencies could also affect the cash flow dynamics of these securitizations and thus extend the period over which we will receive a return of principal from these investments. In most cases, adverse changes in anticipated cash flows would reduce our economic and accounting returns and may also precipitate mark-to-market charges to earnings. From time to time, we may pledge these interests as collateral for borrowings; a deterioration of credit results in this portfolio may adversely affect the terms or availability of these borrowings and, thus, our liquidity.

We generally expect to increase our net acquisitions of residential credit-enhancement securities and to increase our net acquisitions of first loss and second loss investments relative to third loss investments. This may result in increased risk with respect to the credit results of the residential loans we credit enhance.

In our credit-enhancement securities portfolio, we may benefit from credit rating upgrades or restructuring opportunities through re-securitizations or other means in the future. If credit results deteriorate, these opportunities may not be available to us or may be delayed. It is likely, in many instances, that we will not be able to anticipate increased credit losses in a pool soon enough to allow us to sell such credit-enhancement interests at a reasonable price.

In anticipation of future credit losses, we designate a portion of the purchase discount associated with many of our credit-enhancement securities as a form of credit protection. The remaining discount is amortized into income over time via the effective yield method. If the credit protection we set aside at acquisition proves to be insufficient, we may need to reduce our effective yield income recognition in the future or we may adjust our basis in these interests, thus reducing earnings.

Decreases in estimated cash flows on certain securities and loans may reduce earnings as a result of declines in market values.

We adopted EITF 99-20 in the first quarter of 2001. Generally, under EITF 99-20, if prospective cash flows from certain investments deteriorate even slightly from prior expectations (due to changes in anticipated credit losses, prepayment rates, and otherwise) then the asset will be marked-to-market if the market value is lower than our basis. Any mark-to-market adjustments under EITF 99-20 reduce earnings in that period. Since we do not expect every asset we own to always perform equal to or better than our expectations, we expect to take negative EITF 99-20 adjustments to earnings from time to time. Any positive adjustments to anticipated future cash flows are generally reflected in a higher yield recognition for that asset for as long as anticipated future cash flows remain favorable.

Our business may be significantly harmed by a slowdown in the economy of California.

Approximately half of the mortgage loans that we own or credit-enhance are secured by property in California. An overall decline in the economy or the residential real estate market, or the occurrence of a natural disaster that is not covered by standard homeowners' insurance policies, such as an earthquake, could decrease the value of mortgaged properties in California. This, in turn, would increase the risk of delinquency, default, or foreclosure on mortgage loans in our residential loan portfolios. This could adversely affect our credit loss experience and other aspects of our business, including our ability to securitize mortgage loans.

We may have credit losses in our securities portfolio.

Most of our securities are backed by residential and commercial real estate loans. Most of these securities benefit from various forms of corporate guarantees and/or from credit enhancement provided by third parties, usually through their ownership of subordinated credit-enhancement interests. Thus, the bulk of our securities investments have at least some degree of protection from initial credit losses that occur in the underlying loan pools. However, in the event of greater than expected future delinquencies, defaults, or credit losses, or a substantial deterioration in the financial strength of any corporate guarantors, our results would likely be adversely affected. We may experience credit losses in our securities portfolio. Deterioration of the credit results or guarantees of these assets may reduce the market value of these assets, thus limiting our borrowing capabilities and access to liquidity. Generally, we do not control or influence the underwriting, servicing, management, or loss mitigation efforts with respect to these assets. Results could be affected through credit rating downgrades, market value losses, reduced liquidity, adverse financing terms, reduced cash flow, experienced credit losses, or in other ways.

For the non-investment grade assets in our securities portfolio, our protection against credit loss is smaller and our credit risks and liquidity risks are increased. If we acquire equity securities, results may be volatile. We intend to continue to increase the percentage of our securities portfolio that is rated below AA and that is rated below investment grade, and we intend to continue to expand the range of types of securities that we acquire; these trends may increase the potential credit risks in our securities portfolio. A substantial portion of these lower rated securities are expected to be acquired in connection with our Acacia program. Many of the loans underlying the securities we have acquired for our securities portfolio are of lesser quality than the loans in our high-quality residential loan portfolios; these lower quality loans can be expected to have higher rates of delinquency and loss, and losses to our security interests could occur. Changes in laws regarding origination practices for lower-quality loans could reduce the value and credit-worthiness of some of our securities and could expose us to litigation. Some of our securities are backed by subprime residential, manufactured housing, second-lien, and diverse commercial real estate loans that have additional risks not typically found with residential real estate loans. Some of our securities are unsecured corporate obligations of REITs that invest in commercial real estate properties; these securities have commercial real estate risk but also may have additional risks associated with unsecured lending to corporations. We may invest in other types of securities that have risks that are not contemplated in this discussion.

We assume direct credit risk in our commercial real estate loan investments.

The loans in our commercial real estate loan portfolio, as well as the loans that collateralize the commercial real estate loan securities we acquire, may have higher degrees of credit and other risks than do our residential mortgage loans, including various environmental and legal risks. The net operating income and market values of commercial real estate properties may vary with economic cycles and as a result of other factors, so that debt service coverage is unstable. The value of the property may not protect the value of the loan if there is a default. Our commercial real estate loans are not geographically diverse, so we are at risk for regional factors. Many of our commercial loans are not fully amortizing, so the timely recovery of our principal is dependent on the borrower's ability to refinance at maturity. We often lend against commercial real estate that is in transition. Such lending entails higher risks than traditional commercial property lending against stabilized properties. Initial debt service coverage ratios, loan-to-value ratios, and other indicators of credit quality may not meet standard market criteria for stabilized commercial real estate loans. The underlying properties may not transition or stabilize as we expected. The personal guarantees and forms of cross-collateralization that we receive on some loans may not be effective. We generally do not service our loans; we rely on our servicers to a great extent to manage our commercial assets and work-out loans and properties if there are delinquencies or defaults. This may not work to our advantage. As part of the work-out process of a troubled commercial real estate loan, we may assume ownership of the property, and the ultimate value of this asset would depend on our management of, and eventual sale of, the property which secured the loan. Our loans are illiquid; if we choose to sell them, we may not be able to do so in a timely manner or for a satisfactory price. Financing these loans may be difficult, and may become more difficult if credit quality deteriorates. We have sold senior loan participations on some of our loans, so that the asset we retain is junior and has concentrated credit, servicing, and other risks. We have directly originated some of our commercial loans, and participated in the origination of others. This may expose us to certain credit, legal, and other risks that may be greater than is usually present with acquired loans. We have sold commercial mortgage loans. The representations and warranties we made on these sales are limited, but could cause losses and claims in some circumstances. On a net basis, we intend to increase our investment in commercial real estate loans and in junior participations of these loans.

Our investments in subordinated commercial mortgage backed securities and loans are subject to losses.

In general, losses on an asset securing a mortgage loan included in a securitization will be borne first by the equity holder of the property, then by a cash reserve fund or letter of credit, if any, and then by the “first loss” subordinated security holder. In the event of default and the exhaustion of any equity support, reserve fund, letter of credit, and any classes of securities junior to those in which we invest, we will not be able to recover all of our investment in the securities we purchase. In addition, if the underlying mortgage portfolio has been overvalued by the originator, or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related mortgage backed securities, the securities in which we invest may effectively become the “first loss” position behind the more senior securities, which may result in significant losses to us.

The prices of lower credit quality securities are generally less sensitive to interest rate changes than more highly rated investments, but more sensitive to adverse economic downturns or individual issuer developments. A projection of an economic downturn, for example, could cause a decline in the price of lower credit quality securities because the ability of obligors of mortgages underlying mortgage backed securities to make principal and interest payments may be impaired. In such event, existing credit support in the securitization structure may be insufficient to protect us against loss of our principal on these securities.

We intend to invest in diverse types of assets with credit risks that could also cause losses.

We intend to continue to invest in a variety of types of commercial real estate loan assets, such as mezzanine loans, second liens, credit-enhancement interests of commercial loan securitizations, junior participations, among others, that may entail other types of risks. In addition, we intend to continue to invest in other assets with material credit risk, including sub-prime residential real estate loans and securities, the equity and debt of CDOs, corporate debt and equity of REITs and non-real estate companies, trust preferreds from banks, real estate and non-real estate asset-backed securities, and other financial and real property assets.

Our results could also be adversely affected by counter-party credit risk.

We have other credit risks that are generally related to the counter-parties with which we do business. In the event a counter-party to our short-term borrowings becomes insolvent, we may fail to recover the full value of our collateral, thus reducing our earnings and liquidity. In the event a counter-party to our interest rate agreements becomes insolvent or interprets our agreements with them in an unfavorable manner, our ability to realize benefits from hedging may be diminished, and any cash or collateral that we pledged to these counter-parties may be unrecoverable. We may be forced to unwind these agreements at a loss. In the event that one of our servicers becomes insolvent or fails to perform, loan delinquencies and credit losses may increase. We may not receive funds to which we are entitled. In various other aspects of our business, we depend on the performance of third parties that we do not control. We attempt to diversify our counter-party exposure and to limit our counter-party exposure to strong companies with investment-grade credit ratings, but we are not always able to do so. Our counter-party risk management strategy may prove ineffective.

We may be subject to the risks associated with inadequate or untimely services from third-party service-providers, which may affect our results of operations.

The majority of our loans and securities are serviced by third-party service-providers. These arrangements allow us to increase the volume of the loans we purchase without incurring the expenses associated with servicing operations. However, as with any external service provider, we will be subject to the risks associated with inadequate or untimely services. Many borrowers require notices and reminders to keep their loans current and to prevent delinquencies and foreclosures. A substantial increase in our delinquency rate that results from improper servicing or mortgage loan performance in general could adversely affect our ability to securitize our mortgage loans in the future.

We are exposed to certain risks associated with the accumulation of real estate loan assets prior to securitization.

Our long-term goal is to fund most of our real estate loan investments with long-term non-recourse debt. Prior to securitization, we acquire and accumulate loans and securities with short-term recourse debt or equity. During this accumulation period, we are subject to certain risks such as liquidity risk, market value risk, and credit risk. Untimely execution of a securitization may accentuate these risks. In addition, we may not be able to securitized certain assets.

Fluctuations in our results may be exacerbated by the structural leverage that we employ and by liquidity risk.

We employ substantial structural leverage on our balance sheet relative to many financial and non-financial companies, although we believe we employ less leverage on a recourse basis than most banks, thrifts, and other financial institutions. The bulk of our financing is typically in the form of non-recourse debt issued through asset securitization. We believe this is generally an effective and lower-risk form of financing compared to many other forms of debt utilized by financial companies. We believe the amount of leverage that we employ is appropriate, given the risks in our balance sheet, the non-recourse nature of the long-term financing structures that we typically employ, the fact that our maximum credit losses are generally limited, and our management policies. However, in order to operate our business successfully, we require continued access to debt on favorable terms with respect to financing costs, capital efficiency, covenants, and other factors. We may not be able to obtain debt on such terms.

Due to our structural leverage, relatively small changes in asset quality, asset yield, cost of borrowed funds, and other factors could have relatively large effects on us and our stockholders, including fluctuations in earnings and liquidity. Our use of securitizations and the resulting structural leverage may not enhance our returns and could erode our financial soundness. In general, we currently intend to increase our use of structural leverage in the future through asset accumulation funded by securitized non-recourse debt issuance.

Although we do not have a corporate debt rating, the nationally-recognized credit rating agencies have a strong influence on the amount of capital that we hold relative to the amount of credit risk we take. The rating agencies determine the amount of net investment we must make to credit enhance the long-term debt, mostly rated AAA, that we issue to fund our residential loan portfolio. They also determine the amount of principal value required for the credit-enhancement interests we acquire. The rating agencies, however, do not have influence over how we fund our net credit investments nor do they determine or influence many of our other capital and leverage policies. With respect to our short-term debt, our lenders, typically large commercial banks and Wall Street firms, limit the amount of funds that they will advance versus our collateral. We set aide more capital than required by our lenders. However, recourse lenders can increase the amount of capital that they will require of us, or the value of our collateral may decline, thus reducing our liquidity.

We are not regulated by the national regulatory bodies that regulate banks, thrifts, and the U.S. government-sponsored real estate loan investment companies Fannie Mae and Freddie Mac. Thus, the amount of financial leverage that we employ is largely controlled by management, and by our internal risk-adjusted capital policies.

In the period in which we are accumulating loans, securities, or other assets in order to build a portfolio of efficient size to issue securitized long-term debt, variations in the market for these assets or for long-term debt issuance could affect our results. Ultimately we may not be able to issue long term debt, the cost of such debt could be greater than we anticipated, the net investment in our financing trust required by the rating agencies could be greater than anticipated, certain of our assets could not be accepted into the financing trust, the market value of our assets to be sold into the financing trust may have changed, our hedging activities or agreements with counter-parties may have been ineffective, or other negative effects could occur.

We may borrow on a short-term basis to fund a portion of our securities portfolio, certain credit-enhancement securities, residential loans, or other assets prior to the issuance of long-term debt, to use a certain amount of leverage with respect to our net investments in credit-enhancement interests, to fund a portion of our commercial loan portfolio, to fund working capital and general corporate needs, and for other reasons. We borrow short-term by pledging our assets as collateral. We can usually borrow via uncommitted borrowing facilities for the substantial majority of our short-term debt because the assets pledged as collateral are generally liquid, have active trading markets, and have readily discernable market prices. The term of these borrowings can range from one day to one year. To fund less liquid or more specialized assets, we typically enter into credit line agreements from commercial banks and finance companies with a one-year term. Whether committed or not, we need to roll over short-term debt on a frequent basis; our ability to borrow is dependent on our ability to deliver sufficient market value of collateral to meet lender requirements. Our payment of commitment fees and other expenses to secure borrowing lines may not protect us from liquidity issues or losses. Variations in lenders' ability to access funds, lender confidence in us, lender collateral requirements, available borrowing rates, the acceptability and market values of our collateral, and other factors could force us to utilize our liquidity reserves or to sell assets, and, thus, affect our liquidity, financial soundness, and earnings. In recent years, we believe that the marketplace for our type of secured short-term borrowing has been stable, but there is no assurance that such stability will continue. Our current intention is to maintain relatively low levels of short-term debt over time, with the exception of short-term debt used to fund assets under accumulation for a securitization. Our plans may change, however. In the future, we may also borrow on an unsecured basis through bank loans, issuance of unsecured corporate debt, and other means.

Our various borrowing arrangements subject us to debt covenants. While these covenants have not meaningfully restricted our operations to date, they could be restrictive or harmful to us and our shareholders' interests in the future. Should we violate debt covenants, we may incur expenses, losses, or reduced ability to access debt.

Prior to and during 2003, a portion of our equity capital base included convertible preferred stock. On May 2, 2003, we redeemed all outstanding shares of preferred stock by converting those shares into shares of common stock. Prior to conversion, our Class B preferred stock had a dividend rate of at least $0.755 per share per quarter, and had certain rights to dividend distributions and preferences in liquidation that were senior to common stockholders.

Disruptions in mortgage securitization market may adversely affect our earnings and growth.

We depend upon the issuance of long-term debt through securitizations. If the market for such securitizations should become disrupted, as occurred in 1998 due to a liquidity crisis in debt markets generally, we may be unable to issue our securities, in which event our ability to continue to acquire mortgage assets would be adversely impacted. In addition, if the securitization market were to experience a long-term disruption, for example, due to an adverse court decision or bankruptcy law change relating to the bankruptcy-remote structures of the securitizations, our ability to issue long-term debt securitizations may be impaired or eliminated for a protracted period or permanently. In such event, our earnings and ability to grow may be adversely affected.

Changes in the market values of our assets and liabilities can adversely affect our earnings, stockholders' equity, and liquidity.

The market values of our assets, liabilities, and hedges are affected by interest rates, the shape of yield curves, volatility, credit quality trends, mortgage prepayment rates, supply and demand, capital markets trends and liquidity, general economic trends, expectations about the future, and other factors. For the assets that we mark-to-market through our income statement or balance sheet, such market value fluctuations will affect our earnings and book value. To the extent that our basis in our assets is thus changed, future reported income may be affected as well. If we sell an asset that has not been marked-to-market through our income statement at a reduced market price relative to our basis, our earnings will be reduced. Market value reductions of the assets that we pledge for short-term borrowings may reduce our access to liquidity.

Generally, reduced asset market values for the assets that we own may have negative effects, but might improve our opportunities to acquire new assets at attractive pricing levels. Conversely, increases in the market values of our existing assets may have positive effects, but may mean that acquiring new assets at attractive prices becomes more difficult.

Changes in loan prepayment rates may affect our earnings, liquidity, and the market values of our assets.

Residential and commercial real estate loan prepayment rates are affected by interest rates, borrower behavior and confidence, seasoning of loans, the value of and amount of equity in the underlying properties, prepayment terms of the mortgages, the ease and cost of refinancing, the property turnover rate, media awareness of refinancing opportunities, and many other factors.

Changes in prepayment rates (including prepayments from liquidated defaulted loans) may have multiple effects on our operations. Faster loan prepayment rates may lead to increased premium amortization expenses for premium and interest-only assets, increased working capital requirements, reduced market values for certain types of assets, adverse reductions in the average life of certain assets, adverse changes in hedge ratios, and an increase in the need to reinvest cash to maintain operations. Premium assets may experience faster rates of prepayments than discount assets. Slower prepayment rates may lead to reduced discount amortization income for discount assets, reduced market values for discount and other types of assets, extension of the average life of certain investments at a time when this would be contrary to our interests, adverse changes in hedge ratios, a reduction in cash flow available to support operations and make new investments, and a reduction in new investment opportunities, since the volume of new origination and securitizations would likely decline. Slower prepayment rates may lead to increased credit losses.

The amount of net discount we have on our books is the net of a much larger premium balance and a much larger discount balance. Changes in prepayment rates that are not uniform across products could have a material effect on our earnings. Therefore, our net amortization expense or income can change over time as our asset composition changes through principal repayments, asset purchases, and as we mark our assets to market.

Interest rate fluctuations can have various effects on our company, and could lead to reduced earnings and/or increased earnings volatility.

Our balance sheet and asset/liability operations are complex and diverse with respect to interest rate movements, so we cannot fully describe all the possible effects of changing interest rates. We do not seek to eliminate all interest rate risk. Changes in interest rates, the interrelationships between various interest rates, and interest rate volatility could have negative effects on our earnings, the market value of our assets and liabilities, loan prepayment rates, and our access to liquidity. Changes in interest rates can also affect our credit results.

Generally, rising interest rates could lead to reduced asset market values and slower prepayment rates. Initially, our net interest income may be reduced if short-term interest rates increase, as our cost of funds would likely respond to this increase more quickly than would our asset yields. Within three to twelve months of a rate change, however, asset yields for our adjustable rate mortgages may increase commensurately with the rate increase. Higher short-term interest rates may reduce earnings in the short-term, but could lead to higher long-term earnings, as we earn more on the equity-funded portion of our balance sheet. If we own fixed-rate assets that are funded with floating rate debt, our net interest income from this portion of our balance sheet would be unlikely to recover until interest rates dropped again or the assets matured. Some of our adjustable-rate mortgages have periodic caps that limit the extent to which the coupon we earn can rise or fall, usually 2% annual caps, and life caps that set a maximum coupon. If short-term interest rates rise rapidly or rise so that our mortgage coupons reach their periodic or life caps, the ability of our asset yields to rise along with market rates would be limited, but there may be no such limits on the increase in our liability costs.

Falling interest rates can also lead to reduced asset market values in some circumstances, particularly for prepayment-sensitive, premium, and other assets and for many types of interest rate agreement hedges. Decreases in short-term interest rates can be positive for earnings in the near-term, as our cost of funds may decline more quickly than our asset yields would. For longer time horizons, falling short-term interest rates can reduce our earnings, as we may earn lower yields from the assets that are equity-funded on our balance sheet.

Changes in the interrelationships between various interest rates can reduce our net interest income even in the absence of a clearly defined interest rate trend. For instance, if the short-term interest rate indices that drive our asset yields were to decline relative to the short-term interest rate indices that determine our cost of funds, our net interest income would be reduced. As another example, if short-term interest rates rise relative to long-term interest rates (a flatter or inverted yield curve) then prepayments on our adjustable-rate residential loans would likely increase and this may reduce earnings.

Hedging activities may reduce long-term earnings and may fail to reduce earnings volatility or to protect our capital in difficult economic environments; failure to hedge may also have adverse effects on our results.

We attempt to hedge certain risks through managing certain characteristics of our assets and liabilities, and as we deem appropriate, by entering into various interest rate agreements. The amount and level of interest rate agreements that we have may vary significantly over time. We generally attempt to enter into interest rate hedges that provide an appropriate and efficient method for hedging the desired risk. We may elect accounting treatment under FAS 133 for a portion of our hedges. However, there can be no assurance that electing FAS 133 accounting for certain hedges will improve the quality of our reported earnings or that we will continue to meet the requirements of FAS 133 when elected. In addition, the ongoing requirements of FAS 133 are complex and rigorous; if we fail to meet these requirements we would be required to de-designate our interest rate agreements as hedges under FAS 133 and commence mark-to-market accounting through our Consolidated Statements of Income.

Our quarterly earnings may reflect volatility in earnings that are exaggerated by the resulting accounting treatment for certain hedges.

Hedging against interest rate movements using interest rate agreements (including interest rate swap instruments and interest rate futures) and other instruments usually has the effect over long periods of time of lowering long-term earnings. To the extent that we hedge, it is usually to protect us from some of the effects of short-term interest rate volatility, to lower short-term earnings volatility, to stabilize liability costs, or to stabilize the future cost of anticipated liability issuance. Such hedging may not achieve its desired goals. Using interest rate agreements to hedge may increase short-term earnings volatility, if we elect mark-to-market accounting for our hedges. Reductions in market values of interest rate agreements may not be offset by increases in market values of the assets or liabilities being hedged. Conversely, increases in market values of interest rate agreements may not fully offset declines in market values of assets or liabilities being hedged. Changes in market values of interest rate agreements may require us to pledge significant amounts of collateral or cash. Hedging exposes us to counter-party risks.

We also may hedge by taking short or long positions in U.S. Treasuries, mortgage securities, or other cash instruments. Such hedges may have special basis, liquidity, and other risks.

Maintaining REIT status may reduce our flexibility.

To maintain REIT status, we must follow rules and meet certain tests. In doing so, our flexibility to manage our operations may be reduced. If we make frequent asset sales to persons deemed customers, we could be viewed as a "dealer," and thus subject to entity level taxes. Certain types of hedging may produce non-qualifying income under the REIT rules. Our ability to own non-real estate related assets and earn non-real estate related income is limited. Meeting minimum REIT dividend distribution requirements may reduce our liquidity. Because we must distribute at least 90% of our taxable REIT income as dividends to maintain our REIT status, we may need to raise new equity capital if we wish to grow operations at a rapid pace. Stock ownership tests may limit our ability to raise significant amounts of equity capital from one source. Failure to meet REIT requirements may subject us to taxation, penalties, and/or loss of REIT status. REIT laws and taxation could change in a manner adverse to our operations. To pursue our business plan as a REIT, we generally need to avoid becoming a Registered Investment Company, or RIC. To avoid RIC restrictions, we generally need to maintain at least 55% of our assets in whole loan form or in other related forms of assets that qualify for this test. Meeting this test may restrict our flexibility. Failure to meet this test would limit our ability to leverage and would impose other restrictions on our operations. Our ability to invest in taxable subsidiaries is limited under the REIT rules. Our REIT status affords us certain protections against take-over attempts. These take-over restrictions may not always work to the advantage of stockholders. Our stated goal is to not generate income that would be taxable as unrelated business taxable income, or UBTI, to our tax-exempt shareholders. Achieving this goal may limit our flexibility in pursuing certain transactions. Despite our efforts to do so, we may not be able to avoid creating or distributing UBTI to our stockholders.

We may seek to retain a portion of our earnings from time to time so we can increase our investments in real estate loans and securities; we will be subject to income and excise taxes under the REIT tax rules if we do so. New tax rules regarding dividends have been enacted and there may be future changes to certain provisions of the REIT rules, both of which may reduce some of a REIT's competitive edge relative to non-REIT corporations.

Our cash balances and cash flows may become limited relative to our cash needs.

We need cash to meet our working capital, minimum REIT dividend distribution requirements, and other needs. Cash could be required to pay-down our recourse borrowings in the event that the market values of our assets that collateralize our debt decline, the terms of short-term debt become less attractive, or for other reasons. Cash flows from principal repayments could be reduced should prepayments slow or should credit quality trends deteriorate (in the latter case since, for certain of our assets, credit tests must be met for us to receive cash flows). For some of our assets, cash flows are "locked-out" and we receive less than our pro-rata share of principal payment cash flows in the early years of the investment. Operating cash flow generation could be reduced if earnings are reduced, if discount amortization income significantly exceeds premium amortization expense, or for other reasons. Our minimum dividend distribution requirements could become large relative to our cash flow if our income as calculated for tax purposes significantly exceeds our cash flow from operations. Generally, our cash flow has materially exceeded our cash requirements; this situation could be reversed, however, with corresponding adverse consequences to us. We generally maintain what we believe are ample cash balances and access to borrowings to meet projected cash needs. In the event, however, that our liquidity needs exceed our access to liquidity, we may need to sell assets at an inopportune time, thus reducing our earnings. In an adverse cash flow situation, our REIT status or our solvency could be threatened.

Increased competition could reduce our acquisition opportunities or affect our operations in a negative manner.

We believe that our principal competitors in our business of investing in real estate loans are depositories such as banks and thrifts, mortgage and bond insurance companies, other mortgage REITs, hedge funds and private investment partnerships, life insurance companies, government entities such as Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Banks, mutual funds, pension funds, mortgage originators, overseas entities, and other financial institutions. We anticipate that we will be able to compete effectively due to our relatively low level of operating costs, relative freedom to securitize our assets, our ability to utilize leverage, freedom from certain forms of regulation, focus on our core business, and the tax advantages of our REIT status. Nevertheless, many of our competitors have greater operating and financial resources than we do. Competition from these entities, or new entrants, could raise prices on mortgages and other assets, reduce our acquisition opportunities, or otherwise materially affect our operations in a negative manner. We expect competition to increase.

New assets may not be available at attractive prices, thus limiting our growth and/or earnings.

In order to reinvest proceeds from real estate loan principal repayments, or to deploy new equity capital that we may raise in the future, we need to acquire new assets. If pricing of new assets is unattractive, or if the availability of new assets is much reduced, we may not be able to acquire new assets that will generate attractive returns. Our new assets may generate lower returns than the assets that we have on our balance sheet. Generally, unattractive pricing and availability of new assets is a function of reduced supply and/or increased demand. Supply can be reduced if originations of a particular product are reduced, or if there are few sales in the secondary market of seasoned product from existing portfolios. The supply of new securitized assets appropriate for our balance sheet could be reduced if the economics of securitization become unattractive or if a form of securitization that is not favorable for our balance sheet predominates. Also, assets with a favorable risk/reward ratio may not be available if the risks of owning such assets increase substantially relative to market pricing levels. Increased competition could raise prices to unattractive levels.

Accounting conventions and estimates can change, affecting our reported results and operations.

Accounting rules for the various aspects of our business change from time to time. Changes in accounting rules or the accepted interpretation of these rules can affect our reported income, earnings, and stockholders' equity. Our revenue recognition and other aspects of our reported results are based on estimates of future events. These estimates can change in a manner that adversely affects our results or demonstrate, in retrospect, that revenue recognition in prior periods was too high or too low.

Our policies, procedures, practices, product lines, risks, hedging programs, and internal risk-adjusted capital guidelines are subject to change.

In general, we are free to alter our policies, procedures, practices, product lines, leverage, risks, internal risk-adjusted capital guidelines, and other aspects of our business. We can enter new businesses or pursue acquisitions of other companies. In most cases, we do not need to seek stockholder approval to make such changes. We will not necessarily notify stockholders of such changes.

We depend on key personnel for successful operations.

We depend significantly on the contributions of our executive officers and staff. Many of our officers and employees would be difficult to replace. The loss of any key personnel could materially affect our results.

Investors in our common stock may experience losses, volatility, and poor liquidity, and we may reduce our dividends in a variety of circumstances.

Our earnings, cash flow, book value, and dividends can be volatile and difficult to predict. Investors should not rely on predictions or management beliefs. Although we seek to pay a regular common stock dividend rate that is sustainable, we may cut our dividend rate in the future for a variety of reasons. We may not provide public warnings of such dividend reductions prior to their occurrence. Fluctuations in our current and prospective earnings, cash flow, and dividends, as well as many other factors such as perceptions, economic conditions, stock market conditions, and the like, can affect our stock price. Investors may experience volatile returns and material losses. In addition, liquidity in the trading of our stock may be insufficient to allow investors to sell their stock in a timely manner or at a reasonable price.

CERTAIN FEDERAL INCOME TAX CONSIDERATIONS

The following discussion summarizes certain Federal income tax considerations relevant to Redwood Trust and its stockholders. This discussion is based on existing United States Federal income tax law, which is subject to change, possibly retroactively. This discussion does not address all aspects of United States Federal income taxation that may be relevant to a particular stockholder in light of its personal investment circumstances or to certain types of investors subject to special treatment under the Federal income tax laws (including financial institutions, insurance companies, broker-dealers and, except to the limited extent discussed below, tax-exempt entities and foreign taxpayers) and it does not discuss any aspects of state, local or foreign tax law. This discussion assumes that stockholders will hold their common stock as a "capital asset" (generally, property held for investment) under the Code. Stockholders are advised to consult their tax advisors as to the specific tax consequences to them of purchasing, holding, and disposing of the common stock, including the application and effect of Federal, state, local, and foreign income and other tax laws.

In reading this Form 10K and the tax disclosure set forth below, it should be noted that although Redwood Trust is combined with all of its subsidiaries for financial accounting purposes, for Federal income tax purposes, only Redwood Trust and Sequoia Mortgage Funding Corporation (and their assets and income) constitute the REIT, and Redwood Trust's remaining domestic subsidiaries constitute a separate consolidated group subject to regular corporate income taxes. Redwood's foreign subsidiaries, (i.e., Acacia CDO 1, Ltd., Acacia CDO 2, Ltd., and Acacia CDO 3, Ltd.), are not subject to U.S. corporate income taxes (see discussion below under Taxable REIT Subsidiaries).

General

Redwood Trust elected to be taxed as a REIT for Federal income tax purposes, commencing with its tax year ended December 31, 1994. Management currently expects that Redwood Trust will continue to operate in a manner that will permit Redwood Trust to maintain its qualifications as a REIT. This treatment will permit Redwood Trust to deduct dividend distributions to its stockholders for Federal income tax purposes, thus effectively eliminating the "double taxation" that generally results when a corporation earns income and distributes that income to its stockholders.

There can be no assurance that Redwood Trust will continue to qualify as a REIT in any particular tax year, given the highly complex nature of the rules governing REITs, the ongoing importance of factual determinations, and the possibility of future changes in the circumstances of Redwood Trust. If Redwood Trust failed to qualify as a REIT in any particular year, it would be subject to Federal income tax as a regular, domestic corporation, and its stockholders would be subject to tax in the same manner as stockholders of a regular corporation. In such event, Redwood Trust could be subject to potentially substantial income tax liability in respect of each tax year that it fails to qualify as a REIT as well as the four tax years following the year of the failure and the amount of earnings and cash available for distribution to its stockholders could be significantly reduced.

The following is a brief summary of certain technical requirements that Redwood Trust must meet on an ongoing basis in order to qualify, and remain qualified, as a REIT under the Code.

Stock Ownership Tests

The capital stock of Redwood Trust must be held by at least 100 persons for at least 335 days of a twelve-month year, or a proportionate part of a short tax year. In addition, no more than 50% of the value of Redwood Trust's capital stock may be owned, directly or indirectly, by five or fewer individuals at all times during the last half of the tax year. Under the Code, most tax-exempt entities including employee benefit trusts and charitable trusts (but excluding trusts described in 401(a) and exempt under 501(a)) are generally treated as individuals for these purposes. Redwood Trust must satisfy these stock ownership requirements each tax year. Redwood Trust must solicit information from certain of its stockholders to verify ownership levels and maintain records regarding those who do not respond. Redwood Trust's Articles of Incorporation impose certain repurchase obligations and restrictions regarding the transfer of Redwood Trust's shares in order to aid in meeting the stock ownership requirements. If Redwood Trust were to fail either of the stock ownership tests, it would generally be disqualified from REIT status, unless, in the case of the "five or fewer" requirement, the "good faith" exemption is available.

Asset Tests

For tax years beginning before December 31, 2000, Redwood Trust must generally meet the following asset tests (REIT Asset Tests) at the close of each quarter of each tax year:

(a) at least 75% of the value of Redwood Trust's total assets must consist of qualified real estate assets, government securities, cash, and cash items (75% Asset Test); and

(b) the value of securities held by Redwood Trust but not taken into account for purposes of the 75% Asset Test must not exceed either (i) 5% of the value of Redwood Trust's total assets in the case of securities of any one non-government issuer, or (ii) 10% of the outstanding voting securities of any such issuer.

For tax years beginning after December 31, 2000, Redwood Trust must generally meet the following REIT Asset Tests at the close of each quarter of each tax year:

(a) the 75% Asset Test;

(b) the value of Redwood Trust's assets consisting of securities (other than those includible under the 75% Asset Test) must not exceed 25% of the total value of Redwood Trust's assets;

(c) the value of Redwood Trust's assets consisting of securities of one or more taxable REIT subsidiaries must not exceed 20% of the value of Redwood Trust's total assets; and

(d) the value of securities held by Redwood Trust, other than those of a taxable REIT subsidiary or taken into account for purposes of the 75% Asset Test, must not exceed either (i) 5% of the value of Redwood Trust's total assets in the case of securities of any one non-government issuer, or (ii) 10% of the outstanding vote or value of any such issuer's securities.

In applying the above tests, a REIT is generally required to re-value all of its assets at the end of any quarter in which it acquires a substantial amount of new securities or other property other than qualified real estate assets. Redwood Trust intends to monitor closely the purchase, holding, and disposition of its assets in order to comply with the REIT Asset Tests. Redwood Trust expects that substantially all of its assets will be qualified real estate assets and intends to limit or hold through taxable REIT subsidiaries any assets not qualifying as qualified real estate assets so as to comply with the above REIT Asset Tests. If it is anticipated that the above limits would be exceeded, Redwood Trust intends to take appropriate measures to avoid exceeding such limits, including the disposition of non-qualifying assets within the permitted time periods for cure.

Gross Income Tests

Redwood Trust must generally meet the following gross income tests (REIT Gross Income Tests) for each tax year:

(a) at least 75% of Redwood Trust's gross income must be derived from certain specified real estate sources including interest income and gain from the disposition of qualified real estate assets, foreclosure property or "qualified temporary investment income" (i.e., income derived from "new capital" within one year of the receipt of such capital) (75% Gross Income Test); and,

(b) at least 95% of Redwood Trust's gross income for each tax year must be derived from sources of income qualifying for the 75% Gross Income Test, or from dividends, interest, and gains from the sale of stock or other securities (including certain interest rate swap and cap agreements, options, futures and forward contracts entered into to hedge variable rate debt incurred to acquire qualified real estate assets) not held for sale in the ordinary course of business (95% Gross Income Test).

Redwood Trust intends to maintain its REIT status by carefully monitoring its income, including income from hedging transactions and sales of mortgage assets, to comply with the REIT Gross Income Tests. In accordance with the Code, Redwood Trust will treat income generated by its interest rate caps and other hedging instruments as qualifying income for purposes of the 95% Gross Income Tests to the extent the interest rate cap or other hedging instrument was acquired to reduce the interest rate risks with respect to any indebtedness incurred or to be incurred by Redwood Trust to acquire or carry real estate assets. In addition, Redwood Trust will treat income generated by other hedging instruments as qualifying or non-qualifying income for purposes of the 95% Gross Income Test depending on whether the income constitutes gains from the sale of securities as defined by the Investment Company Act of 1940. Under certain circumstances, for example, (i) the sale of a substantial amount of mortgage assets to repay borrowings in the event that other credit is unavailable or (ii) an unanticipated decrease in the qualifying income of Redwood Trust which results in the non-qualifying income exceeding 5% of gross income, Redwood Trust may be unable to comply with certain of the REIT Gross Income Tests. Inadvertent failures to comply with the REIT Gross Income Tests will not result in disqualification of the REIT if certain disclosure and reasonable cause criteria are met and a 100% tax on the amount equal to the qualified income shortfall is paid. See " — Taxation of Redwood Trust" below for a discussion of the tax consequences of failure to comply with the REIT provisions of the Code.

Distribution Requirement

For tax years before 2001, Redwood Trust was generally required to distribute to its stockholders an amount equal to at least 95% of Redwood Trust's REIT taxable income determined before deduction of dividends paid and by excluding net capital gains. Beginning with the 2001 tax year, this REIT distribution requirement was reduced to 90%. Such distributions must be made in the tax year to which they relate or, if declared before the timely filing of Redwood Trust's tax return for such year and paid not later than the first regular dividend payment after such declaration, in the following tax year.

The IRS has ruled generally that if a REIT's dividend reinvestment plan allows stockholders of the REIT to elect to have cash distributions reinvested in shares of the REIT at a purchase price equal to at least 95% of the fair market value of such shares on the distribution date, then such distributions generally qualify towards this distribution requirement. Redwood Trust maintains a Direct Stock Purchase and Dividend Reinvestment Plan (DRP) and intends that the terms of its DRP will comply with the IRS public ruling guidelines for such plans.

If Redwood Trust fails to meet the distribution test as a result of an adjustment to Redwood Trust's taxable income by the Internal Revenue Service, Redwood Trust may be able to avoid disqualification as a REIT by paying a "deficiency" dividend within a specified time period and in accordance with other requirements set forth in the Code. Redwood Trust would be liable for interest based on the amount of the deficiency dividend. A deficiency dividend is not permitted if the deficiency is due to fraud with intent to evade tax or to a willful failure to file timely tax return.

Qualified REIT Subsidiaries

A Qualified REIT Subsidiary is any corporation in which a REIT owns 100% of the stock issued by such corporation and for which no election has been made to classify it as a taxable REIT subsidiary. Sequoia Mortgage Funding Corporation, a wholly-owned subsidiary of Redwood Trust, is treated as a Qualified REIT Subsidiary. As such its assets, liabilities, and income are generally treated as assets, liabilities, and income of Redwood Trust for purposes of each of the above REIT qualification tests.

Taxable REIT Subsidiaries

A Taxable REIT Subsidiary is any corporation in which a REIT owns stock (directly or indirectly) and for which the REIT and such corporation make a joint election to classify the corporation as a Taxable REIT Subsidiary. Effective January 1, 2001, RWT Holdings, Inc. (Holdings) and Redwood Trust elected to treat Holdings, Sequoia Residential Funding, and Holdings' other subsidiaries as Taxable REIT Subsidiaries of Redwood Trust. In 2002, Redwood Trust made a Taxable REIT Subsidiary election for Acacia CDO 1, Ltd., a newly formed corporation. In 2003, Redwood Trust made a Taxable REIT Subsidiary election for Acacia CDO 2, Ltd., and Acacia CDO 3, Ltd., newly formed corporations. As Taxable REIT Subsidiaries, they are not subject to the REIT asset, income, and distribution requirements nor are their assets, liabilities, or income treated as assets, liabilities, or income of Redwood Trust for purposes of each of the above REIT qualification tests.

Redwood Trust generally intends to make a Taxable REIT Subsidiary election with respect to any other corporation in which it acquires equity or equity-like securities constituting more than 10% by vote or value of such corporation and that is not otherwise a Qualified REIT Subsidiary. However, the aggregate value of all of Redwood Trust's Taxable REIT Subsidiaries must be limited to 20% of the total value of the REIT's assets. In addition, Redwood Trust will be subject to a 100% penalty tax on any rent, interest, or other charges that it imposes on any Taxable REIT Subsidiary in excess of an arm's length price for comparable services. Redwood Trust expects that any rents, interest, or other charges imposed on Holdings or any other Taxable REIT Subsidiary will be at arm's length prices.

Redwood Trust generally expects to derive income from its Taxable REIT Subsidiaries by way of dividends. Such dividends are not real estate source income for purposes of the 75% Gross Income Test. Therefore, when aggregated with Redwood Trust's other non-real estate source income, such income must be limited to 25% of the REIT's gross income each year. Redwood Trust will monitor the value of its investment in, and the distributions from, its Taxable REIT Subsidiaries to ensure compliance with all applicable REIT income and asset tests.

Taxable REIT Subsidiaries doing business in the United States are generally subject to corporate level tax on their net income and generally will be able to distribute only net after-tax earnings to its stockholders, including Redwood Trust, as dividend distributions. Acacia CDOs are considered foreign subsidiaries not engaged in trade or business in the United States for tax purposes and therefore are not subject to U.S. corporate income taxation (although income from Acacia CDOs is generally includable in REIT taxable income and the taxable income of our Taxable REIT Subsidiaries). There is no guarantee that the IRS could not take the position that Acacia CDOs are doing business within the U.S., which would subject them to corporate level tax on their effectively connected U.S. trade or business income. If this were to occur, then the Acacia CDOs would generally only be able to contribute net after-tax earnings to REIT dividend distributions.

Taxation of Redwood Trust

In any year in which Redwood Trust qualifies as a REIT, Redwood Trust will generally not be subject to Federal income tax on that portion of its REIT taxable income or capital gain that is distributed to its stockholders. Redwood Trust will, however, be subject to Federal income tax at normal corporate income tax rates upon any undistributed taxable income or capital gain.

In addition, notwithstanding its qualification as a REIT, Redwood Trust may also be subject to tax in certain other circumstances. As described above, if Redwood Trust fails to satisfy the REIT Gross Income Tests, but nonetheless maintains its qualification as a REIT because certain other requirements are met, it will generally be subject to a 100% tax on the greater of the amount by which Redwood Trust fails either the 75% or the 95% Gross Income Test. Redwood Trust will also be subject to a tax of 100% on net income derived from any "prohibited transaction", which refers to dispositions of property classified as "property held for sale to customers in the ordinary course of business" (i.e."dealer" property). Redwood Trust does not believe that it has or will engage in transactions that would result in it being classified as a dealer or deemed to have disposed of dealer property, however, there can be no assurance that the IRS will agree. If Redwood Trust has (i) net income from the sale or other disposition of "foreclosure property" which is held primarily for sale to customers in the ordinary course of business or

(ii) other non-qualifying income from foreclosure property, it will be subject to Federal income tax on such income at the highest corporate income tax rate. In addition, a nondeductible excise tax, equal to 4% of the excess of required distributions over the amounts actually distributed will be imposed on Redwood Trust for each calendar year to the extent that dividends paid during the year, or declared during the last quarter of the year and paid during January of the succeeding year, are less than the sum of (1) 85% of Redwood Trust's "ordinary income," (2) 95% of Redwood Trust's capital gain net income, plus (3) any undistributed income remaining from earlier years. Redwood Trust may also be subject to the corporate alternative minimum tax, as well as other taxes in certain situations not presently contemplated.

If Redwood Trust fails any of the above described REIT qualification tests in any tax year and the relief provisions provided by the Code do not apply, Redwood Trust would be subject to Federal income tax (including any applicable alternative minimum tax) on its taxable income at the regular corporate income tax rates. Distributions to stockholders in any year in which Redwood Trust fails to qualify as a REIT would not be deductible by Redwood Trust, nor would distributions generally be required to be made under the Code. Further, unless entitled to relief under certain other provisions of the Code, Redwood Trust would also be disqualified from re-electing REIT status for the four tax years following the year in which it became disqualified.

Redwood Trust may also voluntarily revoke its election to be taxed as a REIT, although it has no intention of doing so, in which event Redwood Trust will be prohibited, without exception, from electing REIT status for the year to which the revocation relates and the following four tax years.

Redwood Trust intends to monitor on an ongoing basis its compliance with the REIT requirements described above. In order to maintain its REIT status, Redwood Trust may be required to limit the types of assets that it might otherwise acquire, or hold certain assets at times when it might otherwise have determined that the sale or other disposition of such assets would have been more prudent.

Taxation of Stockholders

For any tax year in which Redwood Trust is treated as a REIT for Federal income tax purposes, distributions (including constructive or in-kind distributions) made to holders of common stock other than tax-exempt entities (and not designated as capital gain dividends) will generally be subject to tax as ordinary income to the extent of Redwood Trust's current and accumulated earnings and profits as determined for Federal income tax purposes. If the amount distributed exceeds a stockholder's allocable share of such earnings and profits, the excess will be treated as a return of capital to the extent of the stockholder's adjusted basis in the common stock, which will not be subject to tax, and thereafter as a taxable gain from the sale or exchange of a capital asset.

Distributions designated by Redwood Trust as capital gain dividends will generally be subject to tax as long-term capital gain to stockholders, to the extent that the distribution does not exceed Redwood Trust's actual net capital gain for the tax year. Alternatively, Redwood Trust can also elect by written notice to its shareholders to designate a portion of its net capital gain income as being retained and pay directly the tax on such net capital gains. In that instance, each shareholder will generally be required to include the deemed capital gains dividend in its income, will be entitled to claim a credit or refund on its tax return for the tax paid by Redwood Trust with respect to such deemed dividend, and will be entitled to increase its tax basis in Redwood Trust shares by an amount equal to the excess of the deemed capital gain dividend over the tax deemed paid by it.

Distributions by Redwood, whether characterized as ordinary income or as capital gain, are not eligible for the corporate dividends received deduction that exists under current law. Furthermore, distributions by Redwood characterized as ordinary income will generally are not subject to the reduced 15% and 5% tax rates otherwise effective for certain types of dividends as of January 1, 2003. However, dividend distributions by Redwood characterized as capital gain distributions recognized subsequent to May 5, 2003, will be subject to the reduced 5% and 15% tax rates made effective by the *Jobs and Growth Relief Reconciliation Tax Act of 2003.*

In the event that Redwood Trust realizes a loss for the tax year, stockholders will not be permitted to deduct any share of that loss. Further, if Redwood Trust (or a portion of its assets) were to be treated as a taxable mortgage pool, or if it were to hold residual interests in REMIC's or FASIT's, any "excess inclusion" income derived there from and allocated to a stockholder would not be allowed to be offset by a net operating loss of such stockholder.

Dividends declared during the last quarter of a tax year and actually paid during January of the following tax year are generally treated as if received by the stockholder on December 31 of the tax year in which they are declared and not on the date actually received. In addition, Redwood Trust may elect to treat certain other dividends distributed after the close of the tax year as having been paid during such tax year, but stockholders will be treated as having received such dividend in the tax year in which the distribution is made.

Generally, a dividend distribution of earnings from a REIT is considered for estimated tax purposes only when the dividend is made. However, effective December 15, 1999, any person owning at least 10% of the vote or value of a closely-held REIT must accelerate recognition of year-end dividends received from the REIT in computing estimated tax payments. Redwood Trust is not currently, and does not intend to be, a closely-held REIT.

Upon a sale or other disposition of the common stock, a stockholder will generally recognize a capital gain or loss in an amount equal to the difference between the amount realized and the stockholder's adjusted basis in such stock, which gain or loss generally will be long-term if the stock was held for more than twelve months. Any loss on the sale or exchange of common stock held by a stockholder for six months or less will generally be treated as a long-term capital loss to the extent of designated capital gain dividends received by such stockholder. If stock is sold after a record date but before a payment date for declared dividends on such stock, a stockholder will nonetheless be required to include such dividend in income in accordance with the rules above for distributions, whether or not such dividend is required to be paid over to the purchaser.

DRP participants will generally be treated as having received a dividend distribution, subject to tax as ordinary income, in an amount equal to the fair market value of the common stock purchased with the reinvested dividend proceeds generally on the date Redwood Trust credits such common stock to the DRP participant's account, plus brokerage commissions, if any, allocable to the purchase of such common stock. DRP participants will have a tax basis in the shares equal to such value. DRP participants may not, however, receive any cash with which to pay the resulting tax liability. Shares received pursuant to the DRP will have a holding period beginning on the day after their purchase by the plan administrator.

If Redwood Trust makes a distribution of stockholder rights with respect to its common stock, such distribution generally will not be treated as taxable when made. However, if the fair market value of the rights on the date of issuance is 15% or more of the value of the common stock, or if the stockholder so elects regardless of the value of the rights, the stockholder must make an allocation of its existing tax basis between the rights and the common stock based on their relative value on the date of the issuance of the rights. On the exercise of the rights, the stockholder will generally not recognize gain or loss. The stockholder's basis in the shares received from the exercise of the rights will be the amount paid for the shares plus the basis, if any, of the rights exercised. Distribution of stockholder rights with respect to other classes of securities holders generally would be taxable based on the value of the rights on the date of distribution.

Redwood Trust is required under Treasury Department regulations to demand annual written statements from the record holders of designated percentages of its stock disclosing the actual and constructive ownership of such stock and to maintain permanent records showing the information it has received as to the actual and constructive ownership of such stock and a list of those persons failing or refusing to comply with such demand.

In any year in which Redwood Trust does not qualify as a REIT, distributions made to its stockholders would be taxable in the same manner discussed above, except that no distributions could be designated as capital gain dividends, distributions would be eligible for the corporate dividends received deduction and may be eligible for the reduced tax rates on dividends (if paid out of previously-taxed earnings), the excess inclusion income rules would not apply, and stockholders would not receive any share of Redwood

Trust's tax preference items. In such event, however, Redwood Trust would be subject to potentially substantial Federal income tax liability, and the amount of earnings and cash available for distribution to its stockholders could be significantly reduced or eliminated.

Taxation of Tax-Exempt Entities

Subject to the discussion below regarding a "pension-held REIT," a tax-exempt stockholder is generally not subject to tax on distributions from Redwood Trust or gain realized on the sale of the common stock or preferred stock, provided that such stockholder has not incurred indebtedness to purchase or hold Redwood Trust's common stock or preferred stock, that its shares are not otherwise used in an unrelated trade or business of such stockholder, and that Redwood Trust, consistent with its stated intent, does not form taxable mortgage pools or hold residual interests in REMIC's or FASIT's that give rise to "excess inclusion" income as defined under the Code. However, if Redwood Trust was to hold a residual interest in a REMIC or FASIT, or if a pool of its assets were to be treated as a "taxable mortgage pool," a portion of the dividends paid to a tax-exempt stockholder may be subject to tax as unrelated business taxable income (UBTI). Although Redwood Trust does not intend to acquire such residual interests or believe that it, or any portion of its assets, will be treated as a taxable mortgage pool, no assurance can be given that the IRS might not successfully maintain that such a taxable mortgage pool exists.

If a qualified pension trust (*i.e.,* any pension or other retirement trust that qualifies under Section 401 (a) of the Code) holds more than 10% by value of the interests in a "pension-held REIT" at any time during a tax year, a substantial portion of the dividends paid to the qualified pension trust by such REIT may constitute UBTI. For these purposes, a "pension-held REIT" is a REIT (i) that would not have qualified as a REIT but for the provisions of the Code which look through qualified pension trust stockholders in determining ownership of stock of the REIT and (ii) in which at least one qualified pension trust holds more than 25% by value of the interest of such REIT or one or more qualified pension trusts (each owning more than a 10% interest by value in the REIT) hold in the aggregate more than 50% by value of the interests in such REIT. Assuming compliance with the ownership limit provisions in Redwood Trust's Articles of Incorporation it is unlikely that pension plans will accumulate sufficient stock to cause Redwood Trust to be treated as a pension-held REIT.

Distributions to certain types of tax-exempt stockholders exempt from Federal income taxation under Sections 501 (c)(7), (c)(9), (c)(17), and (c)(20) of the Code may also constitute UBTI, and such prospective investors should consult their tax advisors concerning the applicable "set aside" and reserve requirements.

State and Local Taxes

Redwood Trust and its stockholders may be subject to state or local taxation in various jurisdictions, including those in which it or they transact business or reside. The state and local tax treatment of Redwood Trust and its stockholders may not conform to the Federal income tax consequences discussed above. Consequently, prospective stockholders should consult their own tax advisors regarding the effect of state and local tax laws on an investment in the common stock.

Certain United States Federal Income Tax Considerations Applicable to Foreign Holders

The following discussion summarizes certain United States Federal tax consequences of the acquisition, ownership and disposition of common stock or preferred stock by an initial purchaser that, for United States Federal income tax purposes, is a "Non-United States Holder". Non-United States Holder is any holder that is: not a citizen or resident of the United States; not a corporation, partnership, or other entity created or organized in the United States or under the laws of the United States or of any political subdivision thereof; and not an estate or trust whose income is includible in gross income for United States Federal income tax purposes regardless of its source. This discussion does not consider any specific facts or circumstances that may apply to particular Non-United States Holder's acquiring, holding, and disposing of common stock or preferred stock, or any tax consequences that may arise under the laws of any foreign, state, local, or other taxing jurisdiction.

Dividends

Dividends paid by Redwood Trust out of earnings and profits, as determined for United States Federal income tax purposes, to a Non-United States Holder will generally be subject to withholding of United States Federal income tax at the rate of 30%, unless reduced or eliminated by an applicable tax treaty or unless such dividends are treated as effectively connected with a United States trade or business. Distributions paid by Redwood Trust in excess of its earnings and profits will be treated as a tax-free return of capital to the extent of the holder's adjusted basis in his shares, and thereafter as gain from the sale or exchange of a capital asset as described below. If it cannot be determined at the time a distribution is made whether such distribution will exceed the earnings and profits of Redwood Trust, the distribution will be subject to withholding at the same rate as dividends. Amounts so withheld, however, will be refundable or creditable against the Non-United States Holder's United States Federal tax liability if it is subsequently determined that such distribution was, in fact, in excess of the earnings and profits of Redwood Trust. If the receipt of the dividend is treated as being effectively connected with the conduct of a trade or business within the United States by a Non-United States Holder, the dividend received by such holder will be subject to the United States Federal income tax on net income that applies to United States persons generally (and, with respect to corporate holders and under certain circumstances, the branch profits tax).

For any year in which Redwood Trust qualifies as a REIT, distributions to a Non-United States Holder that are attributable to gain from the sales or exchanges by Redwood Trust of "United States real property interests" will be treated as if such gain were effectively connected with a United States business and will thus be subject to tax at the normal capital gain rates applicable to United States stockholders (subject to applicable alternative minimum tax) under the provisions of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). Also, distributions subject to FIRPTA may be subject to a 30% branch profits tax in the hands of a foreign corporate stockholder not entitled to a treaty exemption. Redwood Trust is required to withhold 35% of any distribution that could be designated by Redwood Trust as a capital gains dividend. This amount may be credited against the Non-United States Holder's FIRPTA tax liability. It should be noted that mortgage loans without substantial equity or with shared appreciation features generally would not be classified as "United States real property interests."

Gain on Disposition

A Non-United States Holder will generally not be subject to United States Federal income tax on gain recognized on a sale or other disposition of its shares of either common or preferred stock unless (i) the gain is effectively connected with the conduct of a trade or business within the United States by the Non-United States Holder, (ii) in the case of a Non-United States Holder who is a nonresident alien individual and holds such shares as a capital asset, such holder is present in the United States for 183 or more days in the tax year and certain other requirements are met, or (iii) the Non-United States Holder is subject to tax under the FIRPTA rules discussed below. Gain that is effectively connected with the conduct of a business in the United States by a Non-United States Holder will be subject to the United States Federal income tax on net income that applies to United States persons generally (and, with respect to corporate holders and under certain circumstances, the branch profits tax) but will not be subject to withholding. Non-United States Holders should consult applicable treaties, which may provide for different rules.

Gain recognized by a Non-United States Holder upon a sale of either common stock or preferred stock will generally not be subject to tax under FIRPTA if Redwood Trust is a "domestically-controlled REIT," which is defined generally as a REIT in which at all times during a specified testing period less than 50% in value of its shares were held directly or indirectly by non-United States persons. Because only a minority of Redwood Trust's stockholders are believed to be Non-United States Holders, Redwood Trust anticipates that it will qualify as a "domestically-controlled REIT." Accordingly, a Non-United States Holder should not be subject to United States Federal income tax from gains recognized upon disposition of its shares.

Information Reporting and Backup Withholding

Redwood Trust will report to its U.S. stockholders and the Internal Revenue Service the amount of distributions paid during each calendar year, and the amount of tax withheld, if any. Under the backup withholding rules, a stockholder may be subject to backup withholding with respect to distributions paid (at the rate generally equal to the fourth lowest rate of Federal income tax then in effect) unless such holder (a) is a corporation or comes within certain other exempt categories and, when required, demonstrates that fact; or (b) provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with applicable requirements of the backup withholding rules. A stockholder that does not provide Redwood Trust with its correct taxpayer identification number may also be subject to penalties imposed by the Internal Revenue Service. Any amount paid as backup withholding will be creditable against the stockholder's income tax liability. In addition, Redwood Trust may be required to withhold a portion of dividends and capital gain distributions to any stockholders that do not certify under penalties of perjury their non-foreign status to Redwood Trust.

EMPLOYEES

As of March 4, 2004, we employed 50 people at Redwood Trust and its subsidiaries.

Item 2. PROPERTIES

Redwood Trust leases space for their executive and administrative offices at One Belvedere Place, Suite 300, Mill Valley, California 94941, telephone (415) 389-7373.

Item 3. LEGAL PROCEEDINGS

At December 31, 2003, there were no pending legal proceedings to which Redwood Trust was a party or of which any of its property was subject.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of Redwood Trust's stockholders during the fourth quarter of 2003.

PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The following table provides information with respect to compensation plans under which equity securities of the Company are authorized for issuance as of December 31, 2003.

Equity Compensation Plan Information

Plan Category	Number of Securities to be issued upon exercise of outstanding options, warrants, and rights	Weighted-average exercise price of outstanding options, warrants, and rights	Number of securities remaining available for future issuance under equity compensation plans
Equity Compensation:			
Plans approved by security holders*	1,935,598	$ 26.76	239,622
Equity Compensation:			
Plans not approved by security holders	—	—	—
Total	1,935,598	$ 26.76	239,622

* Included in the number of remaining securities available for future issuance under equity compensation plans are 87,135 securities available for the 2002 Redwood Trust, Inc. Employee Stock Purchase Plan and 152,487 securities available for the 2002 Redwood Trust, Inc. Incentive Stock Plan. Please see the Notes to the Consolidated Financial Statement for additional information on these plans. Not included in the number of securities to be issued upon exercise of outstanding options, warrants, and rights (but not available for future issuance) are 29,253 shares of restricted stock and 25,417 deferred stock units.

Redwood Trust's Common Stock is listed and traded on the New York Stock Exchange under the symbol RWT. Redwood Trust's Common Stock was held by approximately 1,700 holders of record on March 4, 2004 and the total number of beneficial stockholders holding stock through depository companies was approximately 20,300. The high and low closing sales prices of shares of the Common Stock as reported on the New York Stock Exchange and the cash dividends declared on the Common Stock for the periods indicated below were as follows:

	Stock Prices		Common Dividends Declared			
	High	Low	Record Date	Payable Date	Per Share	Dividend Type
Year Ended December 31, 2004						
First Quarter (through March 4, 2004)	$62.69	$49.15	3/31/04	4/21/04	$ 0.67	Regular
			3/31/04	4/21/04	$ 0.50	Special
Year Ended December 31, 2003						
Fourth Quarter	$58.10	$41.20	12/31/03	1/21/04	$ 0.65	Regular
			11/28/03	12/5/03	$ 4.75	Special
Third Quarter	$43.90	$37.45	9/30/03	10/21/03	$ 0.65	Regular
Second Quarter	$42.48	$32.51	6/30/03	7/21/03	$ 0.65	Regular
First Quarter	$33.04	$27.52	3/31/03	4/21/03	$ 0.65	Regular
Year Ended December 31, 2002						
Fourth Quarter	$28.07	$23.70	12/31/02	1/21/03	$ 0.63	Regular
			12/31/02	1/21/03	$0.125	Special
Third Quarter	$31.00	$24.22	9/30/02	10/21/02	$ 0.63	Regular
			9/30/02	10/21/02	$0.125	Special
Second Quarter	$31.50	$27.00	6/28/02	7/22/02	$ 0.63	Regular
			6/28/02	7/22/02	$0.125	Special
First Quarter	$27.49	$23.76	3/29/02	4/22/02	$ 0.62	Regular
Year Ended December 31, 2001						
Fourth Quarter	$25.40	$23.83	12/31/01	1/22/02	$ 0.60	Regular
			11/15/01	11/30/01	$ 0.15	Special
Third Quarter	$25.55	$22.85	9/28/01	10/22/01	$ 0.57	Regular
			8/10/01	8/31/01	$ 0.18	Special
Second Quarter	$23.95	$19.57	6/29/01	7/23/01	$ 0.55	Regular
First Quarter	$20.44	$16.81	3/30/01	4/23/01	$ 0.50	Regular

Redwood Trust intends to pay quarterly dividends so long as the minimum REIT distribution rules require it. Redwood Trust intends to distribute to its stockholders, a majority of its taxable income and to maintain its REIT status. All dividend distributions will be made by Redwood Trust at the discretion of the Board of Directors and will depend on the taxable earnings of Redwood Trust, financial condition of Redwood Trust, maintenance of REIT status, and such other factors as the Board of Directors may deem relevant from time to time. No dividends may be paid on the Common Stock unless full cumulative dividends have been paid on the outstanding Preferred Stock. As of April 30, 2003, the full cumulative dividends had been paid on the Preferred Stock. Subsequently, the Preferred Stock was converted into Common Stock.

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Item 6. SELECTED FINANCIAL DATA

The following selected financial data is for the years ended December 31, 2003, 2002, 2001, 2000, and 1999. It is qualified in its entirety by, and should be read in conjunction with the more detailed information contained in the Consolidated Financial Statements and Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Form 10-K.

	Years Ended December 31,				
(in thousands, except per share data)	2003	2002	2001	2000	1999
Statement of Operations Data:					
Interest income	$ 330,976	$ 163,216	$ 144,539	$ 169,261	$ 145,964
Interest expense	(202,861)	(91,705)	(98,069)	(138,603)	(119,227)
Net interest income	128,115	71,511	46,470	30,658	26,737
Operating expenses	(36,895)	(20,005)	(12,747)	(7,752)	(3,660)
Equity in earnings (losses) of RWT Holdings, Inc.	0	0	0	(1,676)	(21,633)
Net unrealized/realized market value gains losses)	46,676	5,111	1,532	(2,296)	284
Provision for income taxes	(5,502)	0	0	0	0
Dividends on Class B preferred stock	(681)	(2,724)	(2,724)	(2,724)	(2,741)
Net income (loss) before change in accounting principle	131,713	53,893	32,531	16,210	(1,013)
Cumulative effect of adopting EITF 99-20	0	0	(2,368)	0	0
Net income (loss) available to common stockholders	$ 131,713	$ 53,893	$ 30,163	$ 16,210	($1,013)
Average common shares — basic	17,759,346	15,177,449	10,163,581	8,793,487	9,768,345
Net income (loss) per share — basic	$ 7.42	$ 3.55	$ 2.97	$ 1.84	($0.10)
Average common shares — diluted	18,586,649	15,658,623	10,474,764	8,902,069	9,768,345
Net income (loss) per share diluted	$ 7.09	$ 3.44	$ 2.88	$ 1.82	($0.10)
Dividends declared per Class B preferred share	$ 0.755	$ 3.020	$ 3.020	$ 3.020	$ 3.020
Regular dividends declared per common share	$ 2.600	$ 2.510	$ 2.22	$ 1.61	$ 0.40
Special dividends declared per common share	$ 4.750	$ 0.375	$ 0.33	$ 0.00	$ 0.00
Total dividends declared per common share	$ 7.350	$ 2.885	$ 2.55	$ 1.61	$ 0.40
Balance Sheet Data: end of period					
Earning assets	$17,543,487	$ 6,971,794	$ 2,409,271	$2,049,188	$2,387,286
Total assets	$17,626,770	$ 7,007,772	$ 2,435,644	$2,082,115	$2,419,928
Short-term debt	$ 236,437	$ 99,714	$ 796,811	$ 756,222	$1,253,565
Long-term debt	$16,782,586	$ 6,397,020	$ 1,313,715	$1,095,835	$ 945,270
Total liabilities	$17,073,442	$ 6,534,739	$ 2,127,871	$1,866,451	$2,209,993
Total stockholders' equity	$ 553,328	$ 473,033	$ 307,773	$ 215,664	$ 209,935
Number of Class B preferred shares outstanding	0	902,068	902,068	902,068	902,068
Number of common shares outstanding	19,062,983	16,277,285	12,661,749	8,809,500	8,783,341
Book value per common share	$ 29.03	$ 27.43	$ 22.21	$ 21.47	$ 20.88
Other Data:					
Average assets	$11,058,272	$ 4,039,652	$ 2,223,280	$2,296,641	$2,293,238
Average borrowings	$10,489,614	$ 3,616,506	$ 1,945,820	$2,070,943	$2,046,132
Average reported total equity	$ 526,808	$ 402,986	$ 254,021	$ 209,987	$ 236,229
GAAP earnings/average reported common equity	25.3%	14.3%	13.3%	8.8%	(0.5%)

Item 7. 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

Statutory "safe harbor" applies to "forward-looking" statements under the Private Securities Litigation Reform Act of 1995 within the meaning of the Securities Act of 1933 and of the Securities Exchange Act of 1934. Forward-looking statements inherently involve certain risks and uncertainties. Any matter discussed in this Form 10-K that is not historical fact or contains estimates may constitute a forward-looking statement. Although we continuously update and revise our estimates, it is not practical to publish all such revisions and, thus no one should assume that any estimates or the results or trends projected in or contemplated by any forward-looking statements would prove to be accurate in the future. Forward-looking statements can be identified by the presence of words such as "may", "will", "believe", "expect", "anticipate", "estimate", "intend", "plan", or similar words and terminology. Actual results and the timing of certain events could differ materially from those addressed in forward-looking statements due to a number of factors, including, among other things: changes in interest rates and market values; changes in prepayment rates; general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the level of liquidity in the capital markets as it affects our ability to finance our real estate asset portfolio; and other factors not presently identified. For a discussion of risk factors, readers should review the section of this Form 10-K entitled "Risk Factors". This Form 10-K 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.

SUMMARY AND OUTLOOK

Redwood Trust is a financial institution located in Mill Valley, California. We invest in real estate loans and securities created from real estate loans. Our largest investment is in high-quality jumbo residential real estate loans and related real estate loan securities. We also invest in commercial real estate loans and various other types of residential and commercial real estate loan securities. We acquire a majority of our residential real estate loans from well-established real estate loan origination companies throughout the United States. We fund the majority of our investments with securitized long-term debt. Our primary financial goal is to maintain steady regular dividend payments to our shareholders.

Our primary source of revenue is interest income consisting of the monthly loan payments made by homeowners and commercial property owners on their loans. Our expenses consist primarily of interest expense on our debt and operating expenses.

Redwood Trust is structured as a Real Estate Investment Trust (REIT). As a REIT, we are required to distribute to shareholders as dividends the majority of the REIT taxable income (our taxable income excluding income earned in non-REIT taxable subsidiaries) that we earn. During 2003 we earned an estimated $171 million of taxable income, of which $163 million was REIT taxable income.

Our GAAP earnings (as calculated in accordance with Generally Accepted Accounting Principles) totaled $132 million or $7.09 per share for 2003, as compared to $54 million or $3.44 per share for 2002, and $30 million or $2.88 per share for 2001. Our 2003 results were driven by the quality of our existing real estate loan investments, a favorable operating environment, excellent credit results, favorable prepayment patterns, increased capital efficiencies, and income generated from discount securities that were called during 2003 at full face value.

During 2003, we continued to satisfy our dividend distribution requirements as a REIT. Our regular dividend rate during 2003 was $0.65 per share per quarter. For the full year of 2003, we declared regular common dividends of $2.60 per share and a special dividend of $4.75 per share. In 2002 and 2001, we declared regular common dividends of $2.51 and $2.22 per share and special dividends of $0.375 and $0.33 per share, respectively. In March 2004, our Board of Directors declared a first quarter 2004 regular dividend of $0.67 per share and a special dividend of $0.50 per share, payable on April 21, 2004 to shareholders of record on March 31, 2004.

Looking ahead, we believe our earnings will continue to benefit from the quality of our existing assets. However, the extraordinary market conditions of the last few years that increased our realized yields on our seasoned assets (attractive acquisition pricing, excellent credit results, and favorable prepayment rate patterns) are unlikely to continue or to be repeated. We also expect to face increased competition, higher acquisition pricing, and a reduced supply of acquisition opportunities. The volume of fixed and hybrid securitizations has decreased as banks and other financial institutions purchase residential real estate loans and hold these assets unsecuritized, and we expect that this increased competition will continue. As our existing earning assets pay down, we will continue to acquire new assets. We believe we can source new assets with attractive return potential, but we do not expect these new assets to generate the same level of yields we are currently enjoying on our more seasoned assets.

Improvements in our return on equity, earnings, and dividends have been driven in part by increased capital efficiencies that we have realized through selling or resecuritizing assets. In achieving these capital efficiencies, we have increased potential earnings sensitivities with respect to credit risk and certain types of prepayment risks. As of the end of 2003, we believe we have completed most of the reallocating and recycling of capital that we intend to undertake, and we believe there are unlikely to be further significant gains in return on equity from our current capital efficiency initiatives.

Overall, we believe we will continue to be a leading competitor as a result of our operating efficiencies, our intense and specialized business focus, and the relationships we have developed with our business partners. Although we believe it is unlikely we will be able to sustain our earnings and special dividend distributions on a per share basis at 2003’s extraordinary levels, we believe we will continue to generate earnings sufficient to sustain our regular dividend rate in the near future.

FIRST QUARTER 2004 UPDATE

The share of residential originations in the overall jumbo real estate loan market that are adjustable-rate has been rising, so origination volumes of the loans we generally acquire have remained strong. We have agreed to acquire $2.6 billion of these loans year-to-date through March 4, 2004. We continue to increase the number of origination companies we acquire loans from as more companies start to originate LIBOR adjustable rate loans. Competition to acquire these loans continues to increase, and prices continue to rise. As a result, our new investments in these assets are unlikely to earn yields as high as our existing portfolio is earning currently, and our exposure to an increase in prepayment rates of adjustable-rate loans is increasing. We have completed two “Sequoia” program securitizations of residential loans thus far in the first quarter. We were able to issue securities at tighter spreads to LIBOR than in the past; tighter spreads reduce our cost of funds and partially offset the effect of the higher prices we are paying for loans. Also, as part of our on-going efforts to recycle capital to improve capital efficiency, we completed a re-securitization of interest-only securities retained from our Sequoia securitizations, thus freeing $16 million of equity capital for reinvestment.

We continue to acquire residential loan credit-enhancement securities at a pace consistent with 2003, agreeing to acquire $22 million in market value of these securities year-to-date through March 4, 2003. In January, we sold residential loan credit-enhancement securities with a principal value of $23 million (originally rated BB, some have been upgraded) that had significantly appreciated, generating a GAAP gain of $6 million. After this sale, almost all of our BB-rated residential credit-enhancement securities have been sold, called, or re-securitized via our Acacia CDO program. The remainder of our residential loan credit-enhancement portfolio is rated single-B or is unrated; we hold these securities with equity capital (without leverage). In January and February 2004, residential loan credit-enhancement securities with a principal value of $20 million were called, generating a GAAP gain of $12 million. Rapid prepayments, strong credit results, and rising housing prices continue to benefit this portfolio.

We continue to acquire commercial real estate loans securities for our Acacia CDO program, and we have commenced acquisitions of unrated and single-B rated commercial credit-enhancement securities.

We intend to price our fourth Acacia CDO securitization during the first quarter of 2004. Year-to-date — through March 4, 2004 — we agreed to acquire $80 million diverse real estate securities as collateral for our Acacia program. We are buying residential and commercial real estate loan securities for this transaction at significantly tighter spreads (effectively, lower yields and higher prices) than in the past. Competition for these assets is increasing as new entrants and established competitors in the real estate CDO market seek to accumulate assets. We expect our returns from our retained equity in Acacia CDO 4 will be attractive despite higher acquisition pricing for the underlying assets, as spreads over LIBOR for the CDO securities we intend to issue to fund these assets have also tightened.

New mortgage REITs are being formed and are seeking equity capital, and some residential real estate loan originators are converting to mortgage REITs. Some of these firms will likely compete with us in the future. Meanwhile, banks continue to acquire and retain significant amounts of loans for their balance sheets, thus reducing the amount of real estate loans, credit-enhancement securities, and securities suitable for Acacia that we have the opportunity to acquire.

Although asset acquisition prices continue to increase and the opportunity to generate extraordinary returns from real estate assets has lessened, we continue to create new investments that we believe will be generally attractive to shareholders over time. To fund our anticipated acquisitions, we currently plan to continue to issue new common shares during the year through our Direct Stock Purchase and Dividend Reinvestment Plan and also through one or more equity offerings. To the extent stock issuance occurs at prices in excess of book value per share, earnings and dividends per share in the future may benefit because we will have a greater amount of cash (equity) per share available to generate cash flow. Stock issuance may, however, reduce the amount of special dividends on a per-share basis that would otherwise be payable in 2004 and/or 2005 in the event that we have a strong year of taxable income generation in 2004.

SUPPLEMENTAL FINANCIAL DATA

Supplemental financial data and additional financial measures regarding our operations are available on our web site at www.redwoodtrust.com. None of the information on or hyperlinked from our website is incorporated into this Annual Report on Form 10-K.

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. Management discusses the ongoing development and selection of these critical accounting policies with the Audit Committee of the Board of Directors, and the Audit Committee has reviewed the disclosures provided in this Form 10-K.

Establishing Valuations and Accounting for Changes in Valuations

We estimate the fair value of certain assets and interest rate agreements using available market information and other appropriate valuation methodologies. Valuations of our residential real estate loans held-for-sale are generally done on a pool basis while valuations of our commercial real estate loans held-for-sale, and securities available-for-sale are done on an asset-specific basis. We believe the estimates we use 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, amount and timing of credit losses, supply and demand, liquidity, and other market factors.

In addition to our valuation processes, we are active acquirers and occasional sellers of the assets and interest rate agreements we own. Thus, we have the ability to understand and determine changes in assumptions that are taking place in the marketplace and make appropriate changes in our assumptions for valuing assets in our portfolio. In addition, we generally use third party sources to validate our estimates.

Valuation adjustments to our real estate loans held-for-sale and our trading securities are reported as net unrealized and realized market value gains on our Consolidated Statements of Income in the applicable period of the adjustment. In general, adjustments to the fair value of our securities available-for-sale are reported through our balance sheet as a component of accumulated other comprehensive income in Stockholders' Equity within the cumulative unrealized gains and losses classified as accumulated other comprehensive income. The exception to this treatment of our securities available-for-sale is when a specific impairment is identified or a decrease in fair value results from a decline in estimated cash flows that may be considered an other-than-temporary change. In such cases, the resulting decrease in fair value is recorded in net unrealized and realized market value gains (losses) on our Consolidated Statements of Income in the applicable period of the adjustment.

We review our fair value calculations on an ongoing basis. We monitor the critical performance factors for each loan and security. Our expectations of future performance are shaped by input and analyses received from external sources, internal models, and our own judgment and experience. We constantly review our existing assumptions relative to our and the market's expectations of future events and make adjustments to the assumptions that may change our market values and yields. Changes in perceptions regarding future events can have a material impact on the value of our assets. Should such changes, or other factors, result in significant changes in the market values, our net income and/or book value could be adversely affected.

Revenue Recognition

When recognizing revenue on our earning assets, we employ the effective yield method to account for purchase premiums, discounts, and other net capitalized fees or costs associated with purchasing and financing our real estate loans and securities. The use of this method requires us to project cash flows over the remaining life of each asset and certain liabilities. These 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, estimates regarding the likelihood and timing of calls of securities at par, and other factors. We review our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience. We constantly review our assumptions and make adjustments to the cash flows as deemed necessary. 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.

Under the effective yield method, decreases in our credit loss assumptions imbedded in our cash flow forecasts could result in increasing yields being recognized from our current portfolio of residential loan credit-enhancement securities. In addition, faster-than-anticipated prepayment rates would also tend to increase realized yields over the remaining life of the asset. In contrast, increases in our credit loss assumptions and/or slower than anticipated prepayment rates could result in lower yields being recognized under the effective yield method and may represent a permanent impairment, in which case the asset may be written down to its fair value through the Consolidated Statement of Income.

Credit Reserves

The credit reserve for our residential real estate loans is adjusted by taking credit provisions through our Consolidated Statements of Income. The reserves are the result of estimates of collective loan impairment considering historical loss experience (including industry and rating agency data), current conditions, and adjustments to historic conditions. Our collective loan impairment evaluation may consider several components including, but not limited to, such factors as the age of loans, underwriting standards, business climate, economic conditions, geographic considerations, past performance of similar loans and other observable data including our extensive industry experience.

The amount of credit protection for our residential loan credit-enhancement securities is a designated component of the purchase discount. Our residential loan credit-enhancement securities have below-investment-grade credit ratings and represent subordinated interests in pools of high-quality jumbo residential real estate loans. As a result of these characteristics, we purchase credit-enhancement securities at a discount. A portion of the purchase discount is subsequently accreted as interest income under the effective yield method while the remaining portion of the purchase discount is considered credit protection. The amount of credit protection is based upon our assessment of various factors affecting our assets, including economic conditions, characteristics of the underlying loans, delinquency status, past performance of similar loans, 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.

The credit reserve for our commercial loans is established based on expected credit losses associated with individually impaired loans at the time an expected loss becomes probable and can be reasonably estimated. For certain commercial loans purchased at a discount to the face value of the loan, the credit reserve is a designated component of the purchase discount calculated at the time of purchase, subject to ongoing review.

Many of the assets in our securities portfolio benefit from material forms of credit-enhancement, and, thus no credit reserves have been established to date for these assets. Unrealized losses on these securities are reported as a component of net unrealized and realized market value gains in our Consolidated Statements of Income if the decline in value is considered to represent a permanent impairment.

For all of our earning assets, actual credit losses and the timing of these losses may differ from our estimated losses. Although we continually review and update, as appropriate, all of our assumptions, there can be no assurance that our assumptions used to estimate credit losses, 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.

Accounting for Derivatives Instruments (Interest Rate Agreements)
We incorporate the use of derivative instruments to manage certain risks such as market value risk and interest rate risk. The derivative instruments we employ may include, but are not limited to, interest rate swaps, interest rate options, options on swaps, futures contracts, options on futures contracts, options on forward purchases, and other similar derivatives. We collectively refer to these derivative instruments as "interest rate agreements".

On the date the interest rate agreement is entered into, we designate the interest rate agreement as either (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 instrument).

Prior to the fourth quarter of 2002, we chose not to seek "hedge" accounting treatment for any of our interest rate agreements and therefore all of our derivative instruments were designated as trading instruments and were 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 on our Consolidated Statements of Income. In the fourth quarter of 2002, we began electing hedge accounting for certain of our interest rate agreements. Certain interest rate agreements we enter into are accounted for as cash flow hedges, are recorded at their estimated fair market value, and changes in their fair value are generally reported in accumulated other comprehensive income on our Consolidated Balance Sheets. Any ineffective portions of the cash flow hedges are included in our Consolidated Statements of Income.

We may discontinue hedge accounting prospectively when we determine (1) that the derivative is no longer effective in offsetting changes in the fair value or cash flows of a hedged item; (2) it is no longer probable that the forecasted transaction will occur; (3) a hedged firm commitment no longer meets the definition of a firm commitment; or (4) that designating the derivative as a hedging instrument is no longer appropriate.

RESULTS OF OPERATIONS

Our earnings for 2003 were $132 million, or $7.09 per share, an increase from the $3.44 per share and the $2.88 per share we earned in 2002 and 2001, respectively.

The increase in our earnings for 2003 was primarily a result of improved capital efficiencies, the addition of new assets, increasing yields on our residential credit-enhancement securities, and realized gains from calls of assets. The table below shows earnings and the related per share amounts for the years ended December 31, 2003, 2002, and 2001.

Table 1
Net Income Available to Common Stockholders
(dollars in thousands, except per share data)

	Year Ended December 31,		
	2003	2002	2001
Net Income Available to Common Stockholders	$ 131,713	$ 53,893	$ 30,163
Average Diluted Shares Outstanding	18,586,649	15,658,623	10,474,764
Diluted Earnings Per Share	$ 7.09	$ 3.44	$ 2.88

Net Interest Income

Net interest income was $128 million in 2003, as compared to $72 million and $46 million in 2002 and 2001, respectively. Our net interest income growth is related to the growth in our net employed equity capital during 2003. We also benefited from faster than anticipated prepayment rates on loans underlying our residential loan credit-enhancement securities, an improved asset mix, and strong credit results.

Table 2
Net Interest Income
(dollars in thousands)

	Year Ended December 31,		
	2003	2002	2001
Interest Income	$ 330,976	$163,216	$144,539
Interest Expense	(202,861)	(91,705)	(98,069)
Net Interest Income	$ 128,115	$ 71,511	$ 46,470

Interest Income

Our total interest income was $331 million in 2003, an increase from the $163 million and the $145 million we earned in 2002 and 2001, respectively.

Table 3
Total Interest Income and Yield
(dollars in thousands)

	Year Ended December 31,		
	2003	2002	2001
Interest Income	$ 332,813	$ 174,356	$ 154,890
Net Discount (Premium) Amortization	6,809	(7,832)	(9,584)
Credit Provision Expense	(8,646)	(3,308)	(767)
Total Interest Income	$ 330,976	$ 163,216	$ 144,539
Average Earning Assets	$10,858,311	$3,948,399	$2,152,965
Yield on Earning Assets	3.05%	4.13%	6.71%

Interest income increased from 2002 and 2001 due to growth in our earning assets. This growth offsets a decline in yields on our assets. Most of our reported assets are adjustable-rate residential real estate loans, and yields on these assets decline when short-term interest rates fall.

To provide more 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 loan investing.

Residential Real Estate Loans

Table 4
Residential Real Estate Loans — Interest Income and Yield
(dollars in thousands)

	Year Ended December 31,		
	2003	2002	2001
Interest Income	$ 273,739	$ 110,733	$ 72,499
Net Discount (Premium) Amortization	(29,615)	(11,988)	(6,720)
Interest Income Before Credit Provision	244,124	98,745	65,779
Credit Provision Expense	(8,146)	(3,308)	(767)
Total Interest Income	$ 235,978	$ 95,437	$ 65,012
Average Amortized Cost	$9,932,961	$3,092,755	$1,146,137
Yield	2.38%	3.09%	5.67%

The majority of the residential real estate loans reported on our Consolidated Balance Sheet ($16.2 billion at December 31, 2003) are owned by Sequoia securitization trusts. Unsecuritized residential real estate loans totaled $43 million at December 31, 2003. These unsecuritized residential real estate loans were financed with $39 million of short-term debt at December 31, 2003. Interest income on our residential real estate loans has increased as a result of higher average balances, offset by lower yields. Average balances and premium amortization and credit provision expenses have increased due to our increased rate of loan acquisitions from 2001. Yields on our residential real estate loans have continued to trend down as most of our residential loans have coupon rates that adjust monthly or every six months as a function of the one- or six-month London Inter-Bank Offered Rate (LIBOR). Short-term interest rates such as LIBOR continued adjusting lower during 2002 and 2003, after a sharp decline in 2001.

Residential Loan Credit-Enhancement Securities

Table 5
Residential Loan Credit-Enhancement Securities — Interest Income and Yield
(dollars in thousands)

	Year Ended December 31,		
	2003	2002	2001
Interest Income	$ 30,902	$ 29,297	$ 16,402
Net Discount (Premium) Amortization	37,189	8,130	281
Total Interest Income	$ 68,091	$ 37,427	$ 16,683
Average Amortized Cost	$275,308	$242,404	$137,277
Yield	24.73%	15.44%	12.15%

Total interest income recognized from our residential loan credit-enhancement securities increased significantly during 2003 primarily due to an increase in yields as well as an increase in our net investment in these securities.

The effective yield on residential loan credit-enhancement securities increased in 2003 as a result of rapid prepayments of fixed-rate and hybrid loans underlying the credit-enhancement securities, low credit losses, and a delay of the timing of anticipated credit losses. This resulted in an increase in net discount amortization and the overall yield in this portfolio in 2003, as compared to 2002 and 2001.

Commercial Real Estate Loans

Table 6
Commercial Real Estate Loans — Interest Income and Yield
(dollars in thousands)

	Year Ended December 31,		
	2003	2002	2001
Interest Income	$ 3,678	$ 4,949	$ 7,256
Net Discount (Premium) Amortization	(219)	51	224
Interest Income Before Credit Provision	3,459	5,000	7,480
Credit Provision Expense	(500)	—	—
Total Interest Income	$ 2,959	$ 5,000	$ 7,480
Average Amortized Cost	$29,473	$49,390	$67,864
Yield	10.04%	10.12%	11.02%

The yield on our commercial real estate loan portfolio during the past several years has remained relatively consistent. A majority of our commercial loans and commercial participations have adjustable-rate coupons. However, these loans also have interest rate floors, and therefore the decline in short-term interest rates from 2001 has not had a material impact on the yield of this portfolio. In the fourth quarter of 2003, we established a credit reserve totaling $0.5 million for a loan on a commercial property with significant vacancies.

Securities Portfolio

Table 7
Securities Portfolio — Interest Income and Yield
(dollars in thousands)

	Year Ended December 31,		
	2003	2002	2001
Interest Income	$ 24,076	$ 28,429	$ 57,626
Net Discount (Premium) Amortization	(546)	(4,025)	(3,369)
Total Interest Income	$ 23,530	$ 24,404	$ 54,257
Average Amortized Cost	$532,683	$504,401	$770,936
Yield	4.42%	4.84%	7.04%

The bulk of the securities portfolio reported on our Consolidated Balance Sheet ($742 million out of $845 million at December 31, 2003) have been transferred to Acacia securitization trusts. These re-securitized securities are reported onto Redwood's reported Consolidated Balance Sheet as assets. Interest income earned by the Acacia trusts on these securities is included in our reported interest income. The decrease in interest income on our securities portfolio for 2003 as compared to 2002 and 2001 was the result of lower yields. Yields for the total reported securities portfolio decreased in 2003 as compared to 2002 and 2001 as the coupon rates on adjustable-rate loan securities continued to reset downwards, reflecting a lagged response to previous declines in short-term interest rates. In addition, the yields on newly acquired fixed-rate and hybrid securities were lower than in previous years.

Interest Expense

Our consolidated interest expense has continued to rise relative to prior periods as our consolidated debt balances have increased, offsetting declines in the cost of our reported debt. Our consolidated debt balances include short-term recourse borrowings and also mortgage-backed securities issued by bankruptcy-remote securitization trusts (Sequoia and Acacia) that have been consolidated onto our balance sheet as long-term debt. Our reported long-term debt is non-recourse to Redwood. Payments of principal and interest on our long-term debt are the obligation of the securitization trusts. The cost of our short-term debt has continued to fall with interest rates. Our average short-term debt borrowings have also continued to fall. As a result, our total interest expense on recourse debt has fallen. The interest expense on long-term debt consolidated into our financial statements from securitization trusts has increased as the outstanding balance of securities issued by Sequoia and Acacia has increased. Overall, the yield of these securities issued by Sequoia and Acacia trusts has declined during 2003 to 1.93% from 2.58% and 5.47% in 2002 and 2001, respectively. As a result, our consolidated cost of funds on these securities has declined.

Table 8
Interest Expense
(dollars in thousands)

	Year Ended December 31,		
	2003	**2002**	**2001**
Interest Expense on Long-Term Debt	$ 195,823	$ 71,393	$ 57,668
Average Long-Term Debt	$10,126,303	$2,760,490	$1,054,135
Cost of Funds on Long-Term Debt	1.93%	2.58%	5.47%
Interest Expense on Short-Term Debt	$ 7,038	$ 20,312	$ 40,401
Average Short-Term Debt	$ 363,311	$ 856,016	$ 891,251
Cost of Funds on Short-Term Debt	1.94%	2.37%	4.53%
Total Interest Expense	$ 202,861	$ 91,705	$ 98,069
Average Total Debt	$10,489,614	$3,616,506	$1,945,386
Cost of Funds on Total Debt	1.93%	2.54%	5.04%

Interest Rate Agreements

Redwood, Sequoia, and Acacia enter into interest rate agreements to assist in the management of interest rate risk. Beginning in the fourth quarter of 2002, we expanded our use of interest rate agreements due to asset growth, changes in risk exposures, and other factors. We use these interest rate agreements in an effort to reduce earnings volatility that may arise from our variable-rate liabilities. We utilize cash flow hedge accounting treatment for many of Redwood's interest rate agreements and for Sequoia and Acacia interest rate agreements consolidated onto our balance sheet. Under this accounting treatment, interest rate agreements are reported at fair market value through our Consolidated Balance Sheet, with any ineffective portion of the hedges reflected in our Consolidated Statements of Income through interest expense. We recognized a minimal amount of ineffectiveness on these hedges during 2003. (Also see "Critical Accounting Policies, *Accounting for Derivative Instruments"* and "*Note 7. Interest Rate Agreements"* in our Consolidated Notes To Financial Statements.)

As of December 31, 2003, net unrealized and realized market value losses on total consolidated interest rate agreements equalled $0.4 million; these losses were included in accumulated other comprehensive income on our Consolidated Balance Sheet. This net $0.4 million net balance consists of $0.5 million of realized net losses on interest rate agreements designated as cash flow hedges that have expired or terminated, and $0.1 million of unrealized net gains designated as cash flow hedges that are outstanding at December 31, 2003. The $0.5 million of realized losses will be reclassified to interest expense in our Consolidated Statements of Income over the effective period for the hedged transactions subsequent to December 31, 2003.

Operating Expenses

Operating expenses were $37 million in 2003 as compared to $20 million in 2002 and $13 million in 2001. Fixed operating expenses have increased over the prior year due to increases in the scale of our business. A significant portion of our operating expenses reflect variable performance-based compensation, primarily employee bonus and dividend equivalent rights (DER) expenses. These costs were significantly higher in 2003 as compared to prior years due to stronger financial results. For the years ended December 31, 2003, 2002, and 2001, we accrued bonus and DER expenses of $17 million, $10 million, and $5 million, respectively.

Our operating expenses include the expenses associated with a portion of our stock options that require variable accounting treatment. This 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. We incur this expense when our stock price increases. During 2003, we recognized in operating expenses a variable stock option expense of $5.7 million, as compared to $0.7 million in 2002, and $0.9 million in 2001.

In the fourth quarter of 2003, we adopted, effective January 1, 2003, the fair value method of accounting for stock options expense and related items for all stock options granted since January 1, 2003. For the stock options granted during 2003, the estimated fair value of these options will be amortized as an operating expense on our Consolidated Statements of Income over the options' related vesting period. Any future cash dividend equivalent right (DER) payments on these stock options will be recorded as a payment of dividends and a reduction of retained earnings. For stock options granted prior to 2003, we will continue apply the provisions of APB Opinion No. 25 to record operating expenses for cash DER payments and we will calculate the effect to earnings that the adoption of the fair value method of accounting under SFAS 123 would have caused and disclose such information in the Notes to Consolidated Financial Statements.

Included as a component of Operating Expenses is a provision for excise taxes of $1.2 million and $1.0 million for the years ended December 31, 2003 and 2002. To the extent a REIT's distributions declared are less than 85% of its REIT taxable income in the calendar year plus 100% of the undistributed REIT taxable income from prior calendar years, a REIT incurs a 4% excise tax on the shortfall. No such expense was incurred in 2001.

Provision for Income Taxes

We have retained permanently approximately 10% of the ordinary REIT taxable income we earned in 2003 and we will declare the distribution of the remainder as dividends by September 2004. We will also retain 100% of the taxable income that we earned at our taxable REIT subsidiaries in 2003. We accrued for income taxes on the portion of our total estimated taxable income that we plan to permanently retain. During 2003, we incurred as an expense $5.5 million for income taxes on the Consolidated Statements of Income based on our current estimates of 2003 taxable income. For the years ended December 31, 2002 and 2001, we did not incur income tax expense as we did not permanently retain taxable income in 2002 or 2001.

Our taxable subsidiary RWT Holdings, Inc. ("Holdings") was profitable during 2003. Holdings is currently benefiting from federal net operating loss carry forwards (NOLs), but most of its state NOLs are unavailable during 2003 due to California's 2003 suspension of NOLs. Of the $5.5 million of income taxes accrued in 2003, $0.7 million related to state income taxes based on our current estimates of taxable income generated at Holdings in 2003. During 2004, we may recognize the potential future value of these NOLs as a one-time gain. From that point forward, we will accrue an income tax expense on an on-going basis for Holdings to the extent it remains profitable. See also 'Dividends and Taxable Income" below.

Net Unrealized And Realized Market Value Gains and Losses

Certain assets are marked to market through accumulated other comprehensive income; these adjustments affect our book value but not our net income. For 2003, we reported a net increase in accumulated other comprehensive income of $13.0 million, as compared to an increase of $66.4 million during 2002 and an increase of $2.8 million during 2001. Changes in this account may reflect increases or decreases in the fair value of our earning assets or interest rate agreements during the period, and may also reflect changes due to calls of our securities, write downs to fair value of a portion of our securities, premium or discount amortization of our securities, or amortization of realized gains and losses on our interest rate agreements.

Fluctuations in the market value of certain of our real estate loan assets and interest rate agreements may also affect our net income. The $46.7 million of net unrealized and realized market value gains reported during 2003 on our Consolidated Statements of Income was comprised of $54.4 million of net realized gains related to redemptions (calls) of our credit-enhancement securities and other security sales and $0.4 million of net realized gains related to the sale of residential and commercial real estate loans held-for-sale, offset by $0.5 million of net unrealized losses related to valuation adjustments to our interest rate agreements accounted for as trading instruments and fair value adjustments of a portion of our securities totaling $7.6 million.

Dividends on Preferred Stock

Our distributions of preferred stock dividends have been $0.7 million per quarter over the last several years (including the first quarter of 2003) reflecting a dividend of $0.755 per share on 902,068 preferred shares outstanding. In May 2003, we converted each of the outstanding shares of preferred stock into shares of common stock.

Common Dividends and Taxable Income

Our primary financial goal is to pay a steady regular dividend to our shareholders. Although there are circumstances under which the Board of Directors may decide that it is in the best interest of Redwood Trust and its shareholders to reduce our regular dividend, our current outlook is that our current regular dividend rate is reasonably sustainable, given our current expectations for cash flow generation and other factors.

We estimate that our taxable income totaled $171 million for 2003. Of the estimated $171 million in total taxable income we earned in 2003, $163 million was REIT taxable income, and $8 million was earned at our taxable REIT subsidiary, Holdings. During 2003, taxable income in the form of net capital gains resulting from the call of some of our residential credit-enhancement securities totaled $47 million. We intend to permanently retain $20 million of our total estimated taxable income at Redwood and Holdings (before applicable federal and state income taxes of $6 million). Retaining earnings and deferring distributions should help support future investments in real estate assets as well as increasing our book value per share.

Dividends to shareholders during 2003 totaled $137 million, approximately $35 million of which represented the distribution of REIT taxable income earned in 2002. Based on our estimates of 2003 REIT taxable income, we will enter 2004 with $49 million of undistributed REIT taxable income which we will pay as dividends to our shareholders during 2004. Our estimates of taxable income are subject to change.

Our income from call activity was long-term capital gain income for tax. During 2003 approximately 34% of our dividends distributed were characterized as a distribution of long-term capital gain income, and the remaining 66% were characterized as a distribution of ordinary income. Our tax-paying shareholders may benefit to the degree they can take advantage of the lower tax rate on capital gains versus ordinary income.

Our taxable income differs from our GAAP income for many reasons. For example, our GAAP income is reduced by credit expenses accrued in anticipation of credit losses while taxable income is reduced by credit losses only when they are realized. Additionally, unrealized mark-to-market fluctuations are generally not included in taxable income, and certain compensation-related items are treated differently for GAAP and tax (both in terms of timing and also total expenses over time).

Table 9
Differences Between GAAP Net Income and Estimated Taxable Income
(all dollars in thousands)

	For the Year Ended December 31, 2003	For the Year Ended December 31, 2002	For the Year Ended December 31, 2001
GAAP Net Income	$ 131,713	$ 53,893	$ 30,163
Amortization and credit expenses	39,269	19,998	(4,844)
Operating expenses	5,978	5,723	4,150
Provision for excise tax	1,203	959	0
Mark-to-market adjustments	(7,126)	(3,280)	666
Estimated Total Taxable Income	171,037	77,293	30,135
(Earnings)/losses from taxable subsidiaries	(7,653)	37	(723)
Estimated REIT taxable income	$ 163,384	$ 77,330	$ 29,412

We will generally attempt to avoid acquiring assets or structuring financings or sales at the REIT corporate level that may generate distributions of unrelated business taxable income (UBTI) or excess inclusion income to our shareholders or prohibited transaction taxes on the REIT; there can be no assurance that we will be successful in doing so.

FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES

Earning Assets

Residential Real Estate Loans — Our residential real estate loan portfolio (which includes loans owned by Sequoia trusts that are consolidated onto our balance sheet) grew from $6.2 billion at the beginning of 2003 to $16.2 billion by December 31, 2003. Of the $16.2 billion of residential real estate loan portfolio at December 31, 2003, $43 million were unsecuritized and the remaining were owned by Sequoia. These unsecuritized residential real estate loans were financed with $39 million of short-term debt at December 31, 2003. Redwood sold this $43 million of unsecuritized loans to Sequoia in 2004 and these loans were securitized. Redwood and Sequoia acquired $11.4 billion of adjustable-rate residential mortgage loans during 2003. During 2003, there were $1.3 billion in principal repayments on this portfolio. We plan to continue to expand our relationships with originators and to expand the types of residential loans we acquire. Redwood plans to continue selling its residential loans to Sequoia, and Sequoia intends to continue securitizing these loans. As a result, the consolidated balance of loans and long-term debt reported on our balance sheet is likely to continue to increase.

Residential Loan Credit-Enhancement Securities— At December 31, 2003 and 2002, we owned residential loan credit-enhancement securities with a carrying value equal to market value totaling $379 million and $352 million, respectively. On December 31, 2003, these securities had a principal (face) value of $624 million, an increase of 12% from the $559 million we owned on December 31, 2002. Of the $624 million principal of these securities reported on our balance sheet at December 31, 2003, $147 million principal of these securities were consolidated onto our balance sheet from bankruptcy-remote securitization trusts (Acacia and Sequoia) in which we retained a subordinated interest.

At December 31, 2003 and 2002, the adjusted cost basis of our residential loan credit-enhancement securities was $299 million and $276 million, respectively. We mark these securities to market on our Consolidated Balance Sheets. The $79 million and $77 million difference between our adjusted cost basis and our carrying value represents net unrealized market value gains at December 31, 2003 and 2002, respectively.

Of the $325 million difference between the principal value and adjusted cost basis of these residential loan credit-enhancement securities at December 31, 2003, we designated $201 million as internal credit protection (reflecting our estimate of likely credit losses on the underlying loans over the life of these securities), with the remaining $123 million representing a purchase discount to be accreted into income over time.

During 2003, we acquired residential loan credit-enhancement securities with a principal value of $287 million and we experienced principal payments, including calls, of $216 million. We intend to continue to invest in these securities in 2004.

The total loans underlying these residential loan credit-enhancement securities increased from $59 billion on December 31, 2002 to $68 billion on December 31, 2003. Although the loans we credit enhance increased in total, rapid prepayments of these underlying loans throughout 2003 reduced the amount of loans credit-enhanced by each individual security, and thus reduced potential credit risk for each of the securities.

Residential loan credit-enhancement securities become callable as they season, usually when the current balance of the underlying loans declines under 10% of the original securitized loan balance. Calls are usually beneficial for us in the near-term, as we receive a payment for the full principal value of an asset that, in general, we acquired at a discount to the principal value. Calls typically diminish on-going earnings per share, however, as it is usually our highest yielding assets that get called.

During 2003, residential loan credit-enhancement securities with a principal value of $117 million were called, resulting in net realized gains of $57 million. Of the $57 million of net realized gains related to redemptions (calls) of our credit-enhancement securities recognized on our Consolidated Statements of Income during 2003, $39 million had been recognized as unrealized gains in accumulated other comprehensive income in Stockholders' Equity through December 31, 2002 on our Consolidated Balance Sheet. We expect to realize additional call income in 2004 from the $46 million principal value of residential credit-enhancement securities we owned as of December 31, 2003 that were callable and from other securities that will become callable during 2004. We do not have an accurate way, however, to determine when or if these callable securities will be called.

Commercial Real Estate Loans — Our commercial real estate loan portfolio decreased during 2003 from $29 million at December 31, 2002 to $22 million at December 31, 2003. We structured and acquired six commercial loan subordinated participations totaling $6 million during 2003. We sold a $6 million senior loan participation in one of our commercial whole loans (we accounted for this sale as the issuance of long-term debt). During 2003, we received principal payments totaling $12 million for the payoff of four commercial loans. We plan to continue to invest in more commercial loans and commercial loan participations in the future.

Securities Portfolio — We continue to acquire diverse residential real estate loan securities, commercial real estate loan securities, interests in real estate oriented collateralized debt obligations (CDOs), and corporate bonds issued by REITS, in each case primarily rated AA, A, BBB, and BB. We transfer the securities we acquire to Acacia bankruptcy-remote securitization trusts. Acacia issues CDO asset-backed securities to fund the acquisition of these assets. We consolidate Acacia's assets, and we reflect Acacia's issuance of CDO asset-backed securities as non-recourse long-term debt on our Consolidated Balance Sheet.

Our consolidated securities portfolio totaled $845 million in carrying value on December 31, 2003, of which $644 million were owned by Acacia securitization trusts. During 2003, we acquired securities totaling $566 million and received payments of principal totaling $54 million; as a result, our consolidated securities portfolio grew significantly from the $336 million of securities we reported on a consolidated basis on December 31, 2002.

Prior to the transfer of our securities to Acacia, we finance our acquisitions of securities with short-term recourse debt (typically through a third-party warehouse agreement). At December 31, 2003, we had $167 million of short-term debt outstanding collateralized by our securities portfolio.

Reserves for Credit Losses and Credit Results

Residential Real Estate Loans — The reserve for credit losses on our residential real estate loans is included as a component of our residential real estate loans on our Consolidated Balance Sheet. The balance of this reserve represents estimated losses as of December 31, 2003 and 2002. Our residential real estate loan reserve balance was 0.10% of the current balance of this portfolio as of December 31, 2003, as compared to 0.13% of the current balance of this portfolio as of December 31, 2002. During 2003, 2002, and 2001, the provision for credit losses recorded on our Consolidated Statements on Income was $8.1 million, $3.3 million, and $0.8 million, respectively. Charge offs recorded in this portfolio totaled $0.1 million, $0.2 million, and $0.4 million during 2003, 2002, and 2001, respectively.

Charge-offs on our residential real estate loan portfolio remained at an annualized rate of less than 1 basis point (0.01%) during 2003. Delinquencies increased from $4.1 million at December 31, 2002 to $5.4 million at December 31, 2003. Delinquencies include loans delinquent more than 90 days, in bankruptcy, in foreclosure, and real estate owned. As a percentage of our loan portfolio, delinquencies remained at low levels relative to the U.S. residential real estate loans as a whole and stood at 0.01% of our current loan balances at December 31, 2003. Although our recent credit results were favorable, probable losses exist in the portfolio as of December 31, 2003 and we expect delinquencies and charge-offs of our current residential loans to increase from current levels.

Residential Loan Credit-Enhancement Securities — Credit losses on residential loans that we credit enhance through our ownership of residential loan credit-enhancement securities totaled $4.1 million during 2003. The annualized rate of credit loss was less than 1 basis point (0.01%) of the $68 billion of underlying loans we credit enhanced at December 31, 2003. Some of our residential loan credit-enhancement securities benefit from first or second loss interests held by others (external credit-enhancement). Of the $4.1 million total credit losses to the underlying loans during 2003, $1.0 million were borne by external credit-enhancement while $3.1 million were incurred by us (reducing the principal value of our residential loan credit-enhancement securities by $3.1 million).

Delinquencies (over 90 days, foreclosure, bankruptcy, and REO) in the underlying portfolio of residential loans that we credit enhance were $146 million at December 31, 2002 and $133 million at December 31, 2003. Delinquencies as a percentage of the residential loans we credit enhance decreased from 0.25% at December 31, 2002 to 0.19% at December 31, 2003. We expect delinquencies and losses for our existing residential loan credit-enhancement securities to increase further from their current modest levels, given a weaker economy and the natural seasoning pattern of these loans.

At December 31, 2003, we had $46 million of external credit-enhancement and $201 million of internally-designated credit protection for this portfolio as compared to $63 million of external credit-enhancement and $225 million of internally-designated credit protection as of December 31, 2002. External credit protection serves to protect us from credit losses on a specific asset basis and represents the principal value of interests that are junior to us and are owned by others. The combined balance of external and internally-designated credit protection represented 36 basis points (0.36%) of the $68 billion of loans underlying our credit-enhancement portfolio. The amount of credit protection and the related risks are specific to each credit-enhancement interest.

Commercial Real Estate Loans —We have been investing in commercial real estate loans since 1998. Our first commercial real estate loan became delinquent in the fourth quarter of 2002. We estimated that the net realizable value of this $1 million face value loan was approximately $650,000 and we wrote down the loan in 2002, anticipating a $350,000 loss. We received a payoff of this loan during the third quarter of 2003 totaling $775,000.

Certain business and economic factors — as well as factors particular to each of our other commercial loans — could cause credit concerns and issues on other loans in our portfolio in the future. If this occurs, we may need to provide for future losses on our commercial loans held-for-investment or reduce the reported value for commercial loans held-for-sale. During the fourth quarter of 2003, we wrote down the reported value of a commercial loan held-for-sale by $500,000. In addition, we established a credit reserve of $500,000 on a commercial loan classified as held-for-investment. In both cases, the actions were precipitated by vacancies at the underlying properties.

Securities Portfolio — The securities portfolio consists of real estate loan securities including prime residential, sub-prime residential, manufactured housing, second-lien residential, diverse commercial real estate, real estate CDO securities and equity, and corporate debt issued by REITs that own commercial real estate properties. As investors in these generally investment-grade and BB-rated securities, we are typically exposed to the credit risk of the underlying real estate loans but we also benefit (for most of our assets) from some credit-enhancement that the rating agencies require in order to give these securities an investment-grade or BB rating. We have had no credit losses from this portfolio during the year ended December 31, 2003. However, we incurred unrealized market value write downs of $6.1 million on this portfolio during 2003 which are reflected as a component of net unrealized and realized market value gains on the Consolidated Statements of Income. These write downs were primarily due to increased delinquencies of manufactured housing loans underlying manufactured housing securities in this portfolio. The market values of these securities have declined, and their credit ratings have been downgraded.

Short-Term Debt

Short-term debt was $236 million at December 31, 2003 and $100 million at December 31, 2002. These borrowings have maturities of less than one year and interest rates that change monthly based upon a margin over the one-month LIBOR.

Our strategy is to use short-term debt to fund the accumulation of assets prior to the transfer to Sequoia or Acacia for securitization. Our levels of short-term debt vary from quarter to quarter based on the timing of our asset accumulation activities, and the timing of transfer of assets to Sequoia and Acacia. We believe our short-term debt balances are most likely to remain between $0 and $2 billion.

Long-Term Debt

We currently fund our operations with equity and with short-term debt used to temporarily finance assets prior to their transfer to securitization trusts. The long-term debt on our consolidated balance sheet represents obligations that will be repaid exclusively from the cash flows from the assets that have been transferred to the securitization trusts.

We own subordinated interests in Sequoia and Acacia securitization trusts. These entities issue mortgage and asset-backed securities that are obligations of the securitization trust (and are non-recourse to Redwood). We consolidate the securities issued by these trusts onto our balance sheet as long-term debt. Long-term debt consolidated in this manner totaled $16.8 billion at December 31, 2003 and $6.4

billion at December 31, 2002. The majority of the securities that Sequoia and Acacia issue pay a coupon rate that adjusts every month, every three months, or every six months to either one-, three-, or six-month LIBOR plus a margin.

Sequoia trusts issue mortgage-backed securities to finance residential real estate loans. Sequoia had $16.0 billion of mortgage-backed securities outstanding at December 31, 2003 versus $6.1 billion at December 31, 2002. During 2003, Sequoia issued $11.3 billion of mortgage-backed securities.

Acacia trusts issue asset-backed securities of a type known as collateralized debt obligations ("CDO") to fund their acquisition of real estate securities. Acacia CDO issuance outstanding (principal value) was $840 million and $282 million as of December 31, 2003 and 2002, respectively. Acacia issued $569 million (principal value) of CDO securities during 2003.

Equity Capital

Our common equity base increased 24%, from $447 million at December 31, 2002 to $553 million at December 31, 2003 as a result of $132 million in earnings, $71 million in stock issuance and stock option exercises, a $27 million conversion of preferred stock to common stock in May 2003, and a $13 million net increase in the values of certain assets marked-to-market through our Consolidated Balance Sheet, as offset by $137 million in dividends paid or declared during 2003. We intend 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.

Cash Requirements and Sources of Cash

We require cash to fund our investing and operating activities, service our debt, and fund our dividend distributions. Our primary sources of cash are short-term borrowings, the issuance of mortgage-backed securities accounted for as long-term debt, investment proceeds (including principal and interest payments from our real estate loan investments), and the issuance of common stock.

We purchase real estate loan investments with cash sourced from short-term borrowings prior to financing these assets to maturity with long-term non-recourse debt through Sequoia and Acacia bankruptcy-remote securitization trusts. Our sources of short-term borrowings include repurchase agreements, bank borrowings, and other forms of collateralized short-term borrowings.

After the accumulation period, we finance to maturity our residential real estate loans and certain other real estate securities we have accumulated for Acacia with long-term non-recourse debt by issuing securities through our Sequoia and Acacia securitization trusts. These trusts issue non-recourse mortgage-backed and asset-backed security obligations primarily in a senior/subordinated structure to provide credit-enhancement to the senior security interests in the pool.

Our business depends upon being able to access both the short-term debt market and mortgage-backed and asset-backed securities markets to fund investments in real estate. If these markets are not available in the future, we would only be able to fund new assets to the extent we had equity capital. Our long-term financed assets would not be affected by a lack of liquidity in the debt markets since these assets are financed with securities that are not only non-recourse, but also have payments tied to the related pledged assets. If the securitization markets were not available and financing from short-term debt was not available, assets previously held with short-term debt would have to be sold to the extent we could not finance them with available equity capital.

As required by the governing documents related to each series of securities issuance, the Sequoia and Acacia bond collateral is held in the custody of trustees. Trustees collect principal and interest payments (less servicing and related fees) on the bond collateral and make corresponding principal and interest payments on the securities. These payments are reflected on our Consolidated Statement of Cash Flows under Cash Flows from Financing Activities but are restricted to the payment of securities (accounted for as long-term debt) on a series-by-series basis. Accordingly, such cash flows from one series are not available for payments on any other series or for general corporate purposes. Obligations under our long-term debt are payable solely from the bond collateral and are otherwise non-recourse to Redwood Trust. Typically, cash from the underlying assets is first distributed to the senior securities while any credit losses in the loan pool first reduces the principal of the subordinated interests. At any point in time, a portion of the other assets reported on our Consolidated Balance Sheets includes restricted cash held by securitization trusts to pay holders of Sequoia and Acacia securities.

Off-Balance Sheet Commitments

The majority of our assets are funded with long-term debt issued in securitizations. We consolidate the assets and liabilities of these securitizations and therefore these transactions do not create off balance-sheet commitments.

Our only category of off-balance sheet commitments are the forward purchase commitments we enter into to purchase real estate loan assets. At December 31, 2003, pursuant to the ordinary course of business, we had commitments to purchase $411 million real estate loan investments which settled in January 2004. The fair value remained unchanged from commitment through settlement date.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We seek to manage the risks inherent in our business — including credit risk, liquidity risk, interest rate risk, prepayment risk, market value risk, reinvestment risk, and capital risk — in a prudent manner designed to insure Redwood's longevity. At the same time, we endeavor, to the best of our ability, to provide our shareholders a steady regular dividend. In general, we seek 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 real estate loans. This includes residential real estate loans and loans we effectively "guarantee" or "insure" through the acquisitions of residential loan credit-enhancement securities. We are also exposed to credit risks in our commercial real estate loan portfolio, our residential and commercial real estate securities portfolio, and with counterparties with whom we do business.

The method that we use to account for future credit losses depends upon the type of asset that we own. For our residential real estate loans, we establish a credit reserve based on an estimate of credit losses by taking credit provisions through our Consolidated Statements of Income. For our residential loan credit-enhancement securities, we designate a portion of the purchased discount as a credit reserve upon the acquisition of such assets. In addition, first loss and other credit-enhancement interests that we do not own (that are junior to our positions) act as a form of external credit protection for us on a specific asset basis for some of our assets; these interests junior to ours absorb credit losses in specific pools of underlying real estate loans before our interest in that pool of loans will experience losses.

For our commercial real estate loans, we establish a credit reserve or mark the loan to estimated realizable value when a loan becomes delinquent.

Many of the assets in the securities portfolio benefit from material forms of external credit-enhancement, and, thus no credit reserves have been established to date for these assets. Unrealized losses on these securities are reported as a component of net unrealized and realized market value gains in our Consolidated Statements of Income if the decline in value is considered to represent a permanent impairment. (See "Critical Accounting Policies, *Credit Reserves*" above.)

The establishment of a credit reserve for loans and our credit loss assumptions for securities to calculate long-term yields under the effective yield method under GAAP accounting 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 the underlying loans are charged off. Thus, the timing and recognition of credit losses for GAAP and tax, and for our earnings and our dividends, may differ. An increase in realized credit losses may not affect our GAAP income due to our anticipation of such losses and our credit reserves. They could, however, materially reduce our REIT taxable income and, therefore, our dividend payment obligations. Conversely, our dividend payment obligations may remain high even during periods when future credit losses are expected but have not yet been realized.

Liquidity Risk

Our short-term debt obligations were $236 million at December 31, 2003. These debt obligations were secured by assets accumulated for future transfer to Sequoia and Acacia bankruptcy-remote securitization trusts. The assets securing this debt were high-quality residential real estate loans and investment-grade and BB-rated real estate loan securities.

In periods of reduced liquidity in capital markets, or for other reasons, we may not be able to roll over our maturing short-term debt obligations. In addition, falling asset prices may trigger margin calls. We believe that — in most markets — we could readily sell these assets to satisfy our debt obligations to meet margin calls or other liquidity needs related to this debt. In an adverse market for these assets, however, any such sale of assets may fail to satisfy our debt obligations or liquidity requirements.

At this time, we see no material negative trends that we believe would affect our access to sufficient short-term borrowings or the valuation of the assets we use to secure these borrowings. We plan to continue to utilize short-term borrowings to accumulate real estate loan assets prior to their permanent financing through long-term debt issued from securitization trusts.

We own interests in securitization trusts (such as Sequoia and Acacia) that issue non-recourse mortgage-backed and asset-backed security obligations. Payments of principal and interest by these trusts to the holders of securities issued by these trusts are not the legal obligation of Redwood Trust. We could lose the entire investment we have made in these trusts, but we will not be required to provide any liquidity in the event of a default of one of these trusts on the trust's obligations. Furthermore, Redwood has not pledged the interests it has retained in these trusts to secure short-term borrowings. As the seller of assets to these trusts prior to securitization, in some cases we have the obligation under representation and warranty provisions to repurchase assets from the trusts in limited circumstances such as fraud. We have obtained, however, similar representations and warranties from the companies from whom we acquired the assets. As a result, Redwood's liquidity risk from representations and warranties should be minimal as long as our counterparties meet their obligations. We believe our ownership of interests in these trusts is unlikely to be a source of potential liquidity risk for Redwood.

The table below presents our contractual obligations and commitments as of December 31, 2003, as well as the consolidated obligations of the securitization trusts in which we own an interest. The reported debt appears on our Consolidated Balance Sheet. The operating leases are commitments that are expensed based on the terms of the related contracts. Additional information on these obligations is presented in our Notes to Consolidated Financial Statements.

Table 10
Contractual Obligations and Commitments as of December 31, 2003
(dollars in thousands)

	Payments Due or Commitment Expiration By Period			
	Total	Less than 1 year	1-5 years	After 5 years
Short-Term Debt	$ 236,437	$ 236,437	$ —	$ —
Long-Term Debt, Residential	16,777,137	—	—	16,777,137
Long-Term Debt, Commercial	5,449	—	5,449	—
Operating Leases	8,083	1,246	3,479	3,358

Note: All of our debt is collateralized by our assets and, although the stated maturity is as shown, the liabilities will pay down as the principal of the associated real estate loans or securities pay down.

At December 31, 2003, we had $58 million of unrestricted cash and highly liquid (unpledged) assets available to meet potential liquidity needs. Thus, total available liquidity equaled 25% of our short-term debt balances. At December 31, 2002, we had $39 million of liquid assets, equaling 39% of our short-term debt balances. The decrease in this ratio in 2003 was primarily the result of the timing of transfers of assets to securitization trusts. In each of these periods we had additional borrowing capacity available on short notice if required to provide additional liquidity. While we anticipate maintaining a strong liquidity position, our ratio of liquid assets to short-term debt will fluctuate from quarter to quarter as we continue to fund our residential real estate loans and other securities with short-term borrowings prior to securitization. At this time, we see no indications or materially negative trends that we believe would be likely to cause us a liquidity shortage.

Covenants associated with a portion of our short-term debt generally relate to our tangible net worth, liquidity reserves, and leverage requirements. We have not had, nor do we currently anticipate having, any problems in meeting these covenants. However, many factors, including ones external to us, may affect our ability to meet these covenants and may affect our liquidity in the future.

Interest Rate Risk

Our strategy is to maintain an asset/liability posture on a consolidated basis (including assets owned by and the mortgage and asset-backed debt securities issued by securitization trusts) 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 loan prepayment rates. In general, the interest rate characteristics of the mortgage and asset-backed securities issued by consolidated securitization trusts, as adjusted for outstanding interest rate agreements, closely matches the interest rate characteristics of the assets owned by those trusts. At December 31, 2003, on a consolidated basis, we reported $16.8 billion of adjustable-rate debt funding adjustable-rate assets and $0.2 billion of fixed/hybrid debt funding a portion of our consolidated fixed/hybrid assets. The remainder of our assets (mostly variable-rate assets, but also some hybrid and fixed-rate assets) were funded with equity.

In the past, as a part of our asset/liability strategy, we maintained a slight mismatch between the interest rate adjustment periods of our consolidated adjustable-rate debt and our consolidated adjustable-rate assets (a portion of the six-month adjustable assets were funded with one-month adjustable debt). We have been progressively reducing the amount of this mismatch. Sequoia has been issuing a greater amount of six-month adjustable mortgage-backed securities in order to better match its assets. We have been increasing our hedging activities with the goal of reducing remaining mismatches on a consolidated basis to a non-material amount. This increase in hedging activities is likely to benefit us as compared to our prior level of hedging should short-term interest rates rise. If short-term interest rates increase, the cost of our hedging activities will likely increase. In a flat or falling short-term interest rate environment, our newly increased hedging activities will likely increase our interest expense as compared to our prior practice.

Unlike many financial institutions, we do not own, on a consolidated basis, fixed-rate or hybrid assets funded with variable-rate short-term debt.

Prepayment Risk

We seek to maintain an asset/liability posture that mitigates the effects loan prepayment trends may have on our ability to achieve our long-term objectives. For the development of our business, there are both positive and negative aspects to both slower prepayment rate environments and to faster prepayment rate environments.

Prepayments affect earnings in the near-term primarily through amortization of purchase premium and discount. Amortization income from discount assets may not necessarily offset amortization expenses from premium assets, and vice-versa. Variations in current and projected prepayment rates for individual assets and changes in short-term interest rates (as they affect projected coupons on adjustable rate mortgages, and thus change effective yield calculations) may cause net premium amortization expense or net discount amortization income to vary substantially from quarter to quarter.

Current prepayment trends (slow prepayments on adjustable-rate loans and fast prepayments on fixed-rate and hybrid loans) have been highly favorable for generating economic returns from our existing consolidated assets. In general, higher long-term interest rates (leading to slower fixed rate loan prepayments) and/or a flatter or inverted yield curve (short-term interest rates rising relative to long-term rates, leading to faster adjustable-rate loan prepayments) would be less favorable for current economic returns from our existing assets.

In the longer-term, prepayments affect reinvestment risk and opportunity. We spend considerable effort acquiring and creating new real estate loan assets for our securitization trusts, Sequoia and Acacia. Most of our ownership interests in securitizations are structured to be long-term (typically 5 to 10 year) assets even if the underlying loan collateral prepays quickly. Nevertheless, if fast prepayment rates persist over long periods of time, we will have more capital returned to us sooner than would otherwise be the case.

We will then need to reinvest this capital, and the assets we acquire and create at that time may be more or less attractive than the assets that generated the principal repayments.

Many of our assets are callable when a sufficient amount of the loans underlying a securitization have refinanced or paid down. As a result of recent rapid prepayment speeds, an increasing number of our assets are callable or are likely to become callable in the next two years. We own most of these assets at a discount, so if they are called we may realize a substantial amount of gain on sale for GAAP and capital gain income for tax. In order to maintain core income at current levels over time, however, we would need to reinvest the portion of the proceeds that we retain (after dividends) in assets with equivalent earning power.

Market Value Risk

At December 31, 2003, we reported on a consolidated basis $1.2 billion of assets that were marked-to-market through our balance sheet but not through our income statement. Of these assets, 50% had adjustable-rate coupons, 21% were hybrid loans, and the remaining 29% had fixed-rate coupons. Market value fluctuations of these assets can affect the value of our stockholders' equity base.

At December 31, 2003, we reported on a consolidated basis real estate loans totaling $8 million that we account for on a lower-of-cost-or-market basis for purposes of determining earnings. All these assets had adjustable-rate coupons.

Market value fluctuations for our assets can affect not only our earnings and book value, but also our liquidity, especially to the extent these assets may be funded with short-term borrowings prior to securitization. Most of our real estate assets are loans accounted for as held-for-investment and reported at cost. As these loans are generally transferred to Sequoia at securitization, changes in the market value of the loans do not have an impact on our liquidity.

Recently, we have been increasing the amount of interest rate agreements we own. 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. Our interest rate agreements are reported at market value, with any periodic changes reported through either our income statement or in our balance sheet. Adverse changes in the market values of our interest rate agreements (which would generally be caused by falling interest rates) may require us to devote additional amounts of cash to margin calls.

Inflation Risk

Virtually all of our consolidated 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 taxable 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.

Quantitative Information about Market Risk

The table below incorporates information that may be useful in analyzing certain market value risks on our balance sheet. One scenario regarding potential future principal prepayments and interest rates of our assets and liabilities is presented in this table. There are many assumptions used to generate this information and there can be no assurance that assumed events will occur as anticipated. Future sales, principal repayments, acquisitions, calls, and restructuring could materially change our interest rate risk profile.

For our interest-rate sensitive assets, the table presents principal cash flows and related average interest rates by year of maturity. The forward curve (future interest rates as implied by the yield structure of debt markets) as of December 31, 2003 was used to project the average coupon rates for each year presented, based on the existing characteristics of our portfolio. The timing of principal cash flows includes assumptions on the prepayment speeds of these assets based on their recent prepayment performance and future prepayment performance consistent with this interest rate scenario; actual prepayment speeds will likely vary significantly from these assumptions. Furthermore, this table does not include anticipated credit losses and assumes all of the principal we are entitled to receive will be received. The actual amount and timing of credit losses will affect the principal payments and effective rates during all periods.

As discussed throughout this Form 10-K our future earnings are sensitive to a number of factors and changes in these factors may have a variety of secondary effects that, in turn, will also impact our earnings. In addition, one of the key factors in projecting our income is the reinvestment rate on new assets and there is no reinvestment assumed in this table. The information provided in this table is based on our existing portfolio at December 31, 2003 under one set of assumptions.

QUANTITATIVE INFORMATION ON MARKET RISK

(All Dollars in Thousands) INTEREST RATE SENSITIVE ASSETS		Principal Amounts Maturing and Effective Rates During Period 2004	2005	2006	2007	2008	Thereafter
Residential Real Estate Loans							
Adjustable Rate	Principal Value	3,321,892	3,168,716	2,378,246	1,788,364	1,352,481	4,064,473
	Interest Rate	2.86%	4.08%	5.33%	6.16%	6.84%	6.93%
Hybrid	Principal Value	28,073	2,196	1,658	1,219	899	2,533
	Interest Rate	5.36%	4.46%	5.45%	6.29%	6.97%	7.09%
Residential Loan Credit-Enhancement Securities							
Adjustable Rate	Principal Value	5,605	11,805	21,779	28,137	21,178	75,737
	Interest Rate	2.40%	3.63%	4.90%	5.78%	6.47%	6.61%
Hybrid	Principal Value	50,208	26,725	35,994	45,366	34,020	97,229
	Interest Rate	4.61%	4.72%	4.78%	5.02%	5.85%	6.07%
Fixed	Principal Value	17,366	10,527	7,324	8,667	9,454	116,570
	Interest Rate	6.54%	6.64%	6.68%	6.71%	6.75%	6.78%
Commercial Real Estate Loans							
Adjustable Rate	Principal Value	8,654	146	13,530	181	199	8,470
	Interest Rate	9.41%	11.00%	9.70%	11.00%	11.00%	11.00%
Securities Portfolio							
Adjustable Rate	Principal Value	13,492	39,300	86,512	97,992	54,516	227,173
	Interest Rate	2.95%	4.09%	5.36%	6.20%	6.96%	7.40%
Hybrid	Principal Value	12,200	7,929	10,573	11,897	8,947	25,724
	Interest Rate	4.96%	4.86%	4.93%	5.12%	6.07%	6.91%
Fixed	Principal Value	249	3,682	13,529	13,502	8,867	197,169
	Interest Rate	5.82%	5.83%	5.85%	5.96%	6.01%	5.89%

[Additional columns below]

[Continued from above table, first column(s) repeated]

QUANTITATIVE INFORMATION ON MARKET RISK

(All Dollars in Thousands) INTEREST RATE SENSITIVE ASSETS		At December 31, 2003 Principal Value	Carrying Value	Fair Value
Residential Real Estate Loans				
Adjustable Rate	Principal Value	16,074,170	16,202,291	16,239,760
	Interest Rate		100.80%	101.03%
Hybrid	Principal Value	36,578	36,869	36,744
	Interest Rate		100.79%	100.45%
Residential Loan Credit- Enhancement Securities				
Adjustable Rate	Principal Value	164,241	87,301	87,301
	Interest Rate		53.15%	53.15%
Hybrid	Principal Value	289,543	173,768	173,768
	Interest Rate		60.01%	60.01%
Fixed	Principal Value	169,908	117,658	117,658
	Interest Rate		69.25%	69.25%
Commercial Real Estate Loans				
Adjustable Rate	Principal Value	31,180	22,419	22,419
	Interest Rate		71.90%	71.90%
Securities Portfolio				
Adjustable Rate	Principal Value	518,984	520,166	520,166
	Interest Rate		100.23%	100.23%
Hybrid	Principal Value	77,270	78,593	78,593
	Interest Rate		101.71%	101.71%
Fixed	Principal Value	236,998	245,955	245,955
	Interest Rate		103.78%	103.78%

QUANTITATIVE INFORMATION ON MARKET RISK

(All Dollars in Thousands) INTEREST RATE SENSITIVE LIABILITIES	Principal Amounts Maturing and Effective Rates During Period 2004	2005	2006	2007	2008	Thereafter
SHORT-TERM DEBT						

Reverse Repurchase Agreements	Principal Value	236,437	—	—	—	—	—
and Bank Warehouse Facilities	Interest Rate	1.98%	N/A	N/A	N/A	N/A	N/A
LONG-TERM DEBT							
Variable Rate	Principal Value	3,023,865	3,138,985	2,400,914	1,794,054	1,356,448	4,882,043
	Interest Rate	1.92%	3.23%	4.41%	5.20%	5.83%	5.79%
Hybrid	Principal Value	32,416	N/A	N/A	N/A	N/A	N/A
	Interest Rate	3.46%	N/A	N/A	N/A	N/A	N/A
Fixed Rate	Principal Value	11,074	5,409	3,915	3,370	2,610	5,495
	Interest Rate	5.76%	5.78%	5.77%	5.76%	5.76%	5.76%
Interest Only	Principal Value	N/A	N/A	N/A	N/A	N/A	N/A
	Interest Rate	4.44%	4.44%	4.42%	4.21%	N/A	N/A
INTEREST RATE AGREEMENTS							
Interest Rate Cap (Corridor)	Notional Value	357,181	285,744	220,247	172,339	655,419	—
(Purchased/Sold)	Buy Strike Rate	11.20%	11.20%	11.20%	11.20%	11.23%	N/A
	Sold Strike Rate	12.08%	12.08%	12.08%	12.08%	12.11%	N/A
Eurodollar Futures	Notional Value	(800,000)	N/A	N/A	N/A	N/A	N/A
(Sold)	Sale Price	98.62	N/A	N/A	N/A	N/A	N/A
Interest Rate Swaps	Notional Value	6,582,399	10,075	22,362	26,541	36,711	176,142
(Purchased)	Receive Strike Rate	1.24%	2.98%	4.10%	4.85%	5.42%	5.41%
	Pay Strike Rate	1.24%	4.08%	4.05%	3.96%	3.91%	4.03%

[Additional columns below]

[Continued from above table, first column(s) repeated]

QUANTITATIVE INFORMATION ON MARKET RISK

(All Dollars in Thousands)		At December 31, 2003		
		Principal Value	Carrying Value	Fair Value
INTEREST RATE SENSITIVE LIABILITIES				
SHORT-TERM DEBT				
Reverse Repurchase Agreements	Principal Value	236,437	236,437	236,437
and Bank Warehouse Facilities	Interest Rate		100.00%	100.00%
LONG-TERM DEBT				
Variable Rate	Principal Value	16,596,311	16,565,630	16,608,698
	Interest Rate		99.82%	100.07%
Hybrid	Principal Value	32,416	31,856	32,524
	Interest Rate		98.27%	100.33%
Fixed Rate	Principal Value	31,873	31,873	31,873
	Interest Rate		100.00%	100.00%
Interest Only	Principal Value	N/A	153,227	131,456
	Interest Rate			
INTEREST RATE AGREEMENTS				
Interest Rate Cap (Corridor)	Notional Value	1,690,931	170	170
(Purchased/Sold)	Buy Strike Rate			
	Sold Strike Rate			
Eurodollar Futures	Notional Value	(800,000)	(164)	(164)
(Sold)	Sale Price			
Interest Rate Swaps	Notional Value	6,854,230	(1,788)	(1,788)
(Purchased)	Receive Strike Rate			
	Pay Strike Rate			

* Interest Rate Agreements which represent mirroring transactions are not included in this table.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Consolidated Financial Statements of the Company and the related Notes, together with the Reports of Independent Accountants thereon, are set forth on pages F-1 through F-36 of this Form 10-K and incorporated herein by reference.

Item 9. CHANGES AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

(a) **Evaluation of Disclosure Controls and Procedures**. The Chief Executive Officer and the Chief Financial Officer conclude that Redwood's disclosure controls and procedures are effective based on their evaluation of these controls and procedures as of the end of the period covered by this report.

(b) **Changes in Internal Control Over Financial Reporting** During the period covered by this annual report, there have been no changes in Redwood's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect Redwood's internal control over financial reporting.

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by Item 10 as to directors and executive officers of the Company is incorporated herein by reference to the definitive Proxy Statement to be filed pursuant to Regulation 14A under the headings “Election of Directors” and “Management of the Company.”

Pursuant to Section 303A. of the NYSE Listed Company Manual, the Board of Directors of the Company has adopted (i) Corporate Governance Standards, (ii) a Code of Business Conduct and Ethics applicable to directors, officers and employees of Redwood Trust and (iii) charters for its Audit Committee, Compensation Committee, and Governance and Nominating Committee. The foregoing documents are available on its website at www.redwoodtrust.com and in print at the request of any shareholder.

Item 11. EXECUTIVE COMPENSATION

The information required by Item 11 is incorporated herein by reference to the definitive Proxy Statement to be filed pursuant to Regulation 14A under the heading “Executive Compensation.”

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by Item 12 is incorporated herein by reference to the definitive Proxy Statement to be filed pursuant to Regulation 14A under the heading “Security Ownership of Certain Beneficial Owners and Management.”

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by Item 13 is incorporated herein by reference to the definitive Proxy Statement to be filed pursuant to Regulation 14A under the heading “Executive Compensation — Certain Relationships and Related Transactions.”

PART IV

Item 14. PRINCIPAL AUDITORS FEES AND SERVICES

The information required by Item 14 is incorporated herein by reference to the definitive Proxy Statement to be filed pursuant to Regulation 14A under the heading “Item 2 — Ratification of Independent Public Accountants”.

Item 15. EXHIBITS, CONSOLIDATED FINANCIAL STATEMENTS SCHEDULES AND REPORTS ON FORM 8-K

(a) Documents filed as part of this report:

(1) Consolidated Financial Statements

(2) Schedules to Consolidated Financial Statements:

All Consolidated Financial Statements schedules not included have been omitted because they are either inapplicable or the information required is provided in the Company’s Consolidated Financial Statements and Notes thereto, included in Part II, Item 8, of this Annual Report on Form 10-K.

(3) Exhibits:

Exhibit Number	Exhibit
3.1	Articles of Amendment and Restatement of the Registrant (a)
3.1.1	Certificate of Amendment of the Charter of Registrant (k)
3.2	Articles Supplementary of the Registrant (a)
3.3	Amended and Restated Bylaws of the Registrant (b)
3.3.1	Amended and Restated Bylaws, amended December 13, 1996 (g)
3.3.2	Amended and Restated Bylaws, amended March 15, 2001 (o)
3.3.3	Amended and Restated Bylaws, amended January 24, 2002 (e)
3.3.4	Amended and Restated Bylaws, amended March 21, 2003 (u)
3.4	Articles Supplementary of the Registrant, dated August 14, 1995 (d)
3.4.1	Articles Supplementary of the Registrant relating to the Class B 9.74% Cumulative Convertible Preferred Stock, filed August 9, 1996 (f)
3.4.2	Articles Supplementary of the Registrant, dated April 7, 2003 (w)
4.2	Specimen Common Stock Certificate (a)
4.3	Specimen Class B 9.74% Cumulative Convertible Preferred Stock Certificate (f)
4.4.1	Indenture dated as of October 1, 1997 between Sequoia Mortgage Trust 2 (a wholly-owned consolidated subsidiary of the Registrant) and Norwest Bank Minnesota, N.A., as Trustee (j)
4.4.3	Indenture dated as of October 1, 2001 between Sequoia Mortgage Trust 5 (a wholly-owned consolidated subsidiary of the Registrant) and Bankers Trust Company of California, N.A., as Trustee (p)
4.4.4	Indenture dated as April 1, 2002 between Sequoia Mortgage Trust 6 (a wholly-owned consolidated subsidiary of the Registrant) and Deutsche Bank National Trust Company, as Trustee (i)
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 (l)
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 (q)

Exhibit Number	Exhibit
9.1	Voting Agreement, dated March 10, 2002 (o)
9.1.1	Amended and Restated Voting Agreement, dated February 21, 2003 (u)
10.10	Employment Agreement, dated August 19, 1994, between the Registrant and George E. Bull (a)
10.10.1	Amended and Restated Employment Agreement, George E. Bull III (v)
10.11	Employment Agreement, dated August 19, 1994, between the Registrant and Douglas B. Hansen (a)
10.11.1	Amended and Restated Employment Agreement, Douglas B. Hansen (v)
10.13.1	Employment Agreement, dated March 13, 2000, between the Registrant and Harold F. Zagunis (m)
10.13.2	Employment Agreement, dated March 23, 2002, between the Registrant and Andrew I. Sirkis (o)
10.13.3	Employment Agreement, dated April 20, 2000, between the Registrant and Brett D. Nicholas (o)
10.14	1994 Amended and Restated Executive and Non-Employee Director Stock Option Plan (c)
10.14.1	1994 Amended and Restated Executive Non-Employee Director Stock Option Plan, amended March 6, 1996 (d)
10.14.2	Amended and Restated 1994 Executive and Non-Employee Director Stock Option Plan, amended December 13, 1996 (h)
10.14.3	Amended and Restated Executive and Non-Employee Director Stock Option Plan, amended March 4, 1999 (n)
10.14.4	Amended and Restated Executive and Non-Employee Director Stock Option Plan, amended January 18, 2001 (o)
10.14.5	Amended and Restated Executive and Non-Employee Director Stock Option Plan, amended January 24, 2002 (r)
10.15	2002 Incentive Stock Plan (s)
10.15.1	2002 Incentive Stock Plan, amended through March 4, 2004
10.16	2002 Employee Stock Purchase Plan (s)
10.17	Executive Deferred Compensation Plan (s)
10.17.1	Executive Deferred Compensation Plan, amended through May 8, 2003 (w)
10.18	Forms of Indemnification Agreement for Directors and Executive Officers (x)
10.29.1	Form of Dividend Reinvestment and Stock Purchase Plan (g)
10.29.2	Form of Direct Stock Purchase and Dividend Reinvestment Plan (t)
10.30.2	Office Building Lease, dated [February, 2003].
11.1	Statement re: Computation or Per Share Earnings
21	List of Subsidiaries
23	Consent of Accountants
31.1	Certification of the principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(a) Incorporated by reference to the correspondingly numbered exhibit to the Registration Statement on Form S-11 (33-92272) filed by the Registrant with the Securities and Exchange Commission on May 19, 1995.

(b) Incorporated by reference to the correspondingly numbered exhibit to the Registration Statement on Form S-11 (33-97946) filed by the Registrant with the Securities and Exchange Commission on October 10, 1995.

(c) Incorporated by reference to the correspondingly numbered exhibit to the Registration Statement on Form S-11 (33-94160) filed by the Registrant with the Securities and Exchange Commission on June 30, 1995.

(d) Incorporated by reference to the correspondingly numbered exhibit to the Registration Statement on Form S-11 (333-02962) filed by the Registrant with the Securities and Exchange Commission on March 26, 1996.

(e) Incorporated by reference to the Form 10-K filed by the Registrant with the Securities and Exchange Commission for the fiscal year ended December 31, 2001.

(f) Incorporated by reference to the correspondingly numbered exhibit to the Registration Statement on Form S-11 (333-08363) filed by the Registrant with the Securities and Exchange Commission on July 18, 1996.

(g) Incorporated by reference to the Registration Statement on Form S-3 (333-18061) filed by the Registrant with the Securities and Exchange Commission on January 2, 1997.

(h) Incorporated by reference to the correspondingly numbered exhibit to Form 8-K filed by the Registrant with the Securities and Exchange Commission on January 7, 1997.

(i) Incorporated by reference to the Form 8-K filed by Sequoia Mortgage Funding Corporation with the Securities and Exchange Commission on May 13, 2002.

(j) Incorporated by reference to the Form 8-K filed by Sequoia Mortgage Funding Corporation with the Securities and Exchange Commission on November 18, 1997.

(k) Incorporated by reference to the Form 8-K filed by the Registrant with the Securities and Exchange Commission on July 20, 1998.

(l) Incorporated by reference to the Form 8-K filed by Sequoia Mortgage Funding Corporation with the Securities and Exchange Commission on May 14, 2002.

(m) Incorporated by reference to the Form 10-Q filed by the Registrant with the Securities and Exchange Commission for the fiscal quarter ended March 31, 2000.

(n) Incorporated by reference to the Form 10-Q filed by the Registrant with the Securities and Exchange Commission for the fiscal year ended December 31, 1999.

(o) Incorporated by reference to the Form 10-K filed by the Registrant with the Securities and Exchange Commission for the fiscal year ended December 31, 2000.

(p) Incorporated by reference to the Form 8-K filed by Sequoia Mortgage Funding Corporation with the Securities and Exchange Commission on November 15, 2001.

(q) Incorporated by reference to the Form 8-K filed by Sequoia Mortgage Funding Corporation with the Securities and Exchange Commission on June 13, 2002.

(r) Incorporated by reference to the Form 10-Q filed by the Registrant with the Securities and Exchange Commission for the fiscal quarter ended March 31, 2002.

(s) Incorporated by reference to the Form 10-Q filed by the Registrant with the Securities and Exchange Commission for the fiscal quarter ended June 30, 2002.

(t) Incorporated by reference to the Registration Statement on Form S-3 (333-98861) filed by the Registrant with the Securities and Exchange Commission on August 28, 2002.

(u) Incorporated by reference to the Form 10-K filed by the Registrant with the Securities and Exchange Commission for the fiscal year ended December 31, 2002.

(v) Incorporated by reference to the Form 10-Q filed by the Registrant with the Securities and Exchange Commission for the fiscal quarter ended March 31, 2003.

(w) Incorporated by reference to the Form 10-Q filed by the Registrant with the Securities and Exchange Commission for the fiscal quarter ended June 30, 2003.

(x) Incorporated by reference to the Form 10-Q filed by the Registrant with the Securities and Exchange Commission for the fiscal quarter ended September 30, 2003.

(b) Reports on Form 8-K — The Company filed the following reports on Form 8-K during the fourth quarter of 2003:

Date	Items
10/24/03	Item 7(c) Exhibit (earnings press release) Item 12 Results of Operation and Financial Condition
11/20/03	Item 7(c) Exhibit (supplemental financial information) Item 12 Results of Operation and Financial Condition

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

REDWOOD TRUST, INC.

Dated: March 4, 2004

By: /s/ George E. Bull
George E. Bull
Chairman and Chief Executive Officer

Pursuant to the requirements the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ George E. Bull	George E. Bull Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	March 4, 2004
/s/ Douglas B. Hansen	Douglas B. Hansen Director, President	March 4, 2004
/s/ Harold F. Zagunis	Harold F. Zagunis Vice President, Chief Financial Officer, Treasurer, and Secretary (Principal Financial Officer)	March 4, 2004
/s/ Michael S. Churchill	Michael S. Churchill Vice President, Controller (Principal Accounting Officer)	March 4, 2004
/s/ Richard D. Baum	Richard D. Baum Director	March 4, 2004
/s/ Thomas C. Brown	Thomas C. Brown Director	March 4, 2004
/s/ Mariann Byerwalter	Mariann Byerwalter Director	March 4, 2004
/s/ Greg H. Kubicek	Greg H. Kubicek Director	March 4, 2004
/s/ Charles J. Toeniskoetter	Charles J. Toeniskoetter Director	March 4, 2004
/s/ David L. Tyler	David L. Tyler Director	March 4, 2004

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REDWOOD TRUST, INC.
CONSOLIDATED FINANCIAL STATEMENTS AND
REPORT OF INDEPENDENT AUDITORS
For Inclusion in Form 10-K
Annual Report Filed with
Securities and Exchange Commission
December 31, 2003

REDWOOD TRUST, INC.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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PART I. FINANCIAL INFORMATION
Item 1. CONSOLIDATED FINANCIAL STATEMENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	December 31, 2003	December 31, 2002
ASSETS		
Residential real estate loans	$16,239,160	$6,215,179
Residential loan credit-enhancement securities	378,727	352,479
Commercial real estate loans	22,419	29,270
Securities portfolio	844,714	335,697
Cash and cash equivalents	58,467	39,169
Total earning assets	17,543,487	6,971,794
Restricted cash	21,957	11,755
Accrued interest receivable	39,706	19,087
Principal receivable	13,743	1,214
Other assets	7,877	3,922
Total Assets	$17,626,770	$7,007,772
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Short-term debt	$ 236,437	$ 99,714
Long-term debt, net	16,782,586	6,397,020
Accrued interest payable	16,556	5,267
Accrued expenses and other liabilities	25,472	19,768
Dividends payable	12,391	12,970
Total Liabilities	17,073,442	6,534,739
Commitments and contingencies *(Note 11)*		
STOCKHOLDERS' EQUITY		
Preferred stock, par value $0.01 per share; Class B 9.74% Cumulative Convertible, 0 and 902,068 shares authorized, issued, and outstanding ($0 and $28,645 aggregate liquidation preference)	—	26,517
Common stock, par value $0.01 per share; 50,000,000 and 49,097,932 shares authorized; 19,062,983 and 16,277,285 issued and outstanding	191	163
Additional paid-in capital	517,826	418,701
Accumulated other comprehensive income	82,179	69,146
Cumulative earnings	248,972	116,578
Cumulative distributions to stockholders	(295,840)	(158,072)
Total Stockholders' Equity	553,328	473,033
Total Liabilities and Stockholders' Equity	$17,626,770	$7,007,772

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except share data)

	Year Ended December 31, 2003	2002	2001
Interest Income			
Residential real estate loans	$ 244,124	$ 98,745	$ 65,779
Residential loan credit-enhancement securities	68,091	37,427	16,683
Commercial real estate loans	3,459	5,000	7,480
Securities portfolio	23,530	24,404	54,257
Cash and cash equivalents	418	948	1,107
Interest income before provision for credit losses	339,622	166,524	145,306
Provision for credit losses	(8,646)	(3,308)	(767)
Total interest income	330,976	163,216	144,539
Interest Expense			
Short-term debt	(7,038)	(20,312)	(40,401)
Long-term debt	(195,823)	(71,393)	(57,668)
Total interest expense	(202,861)	(91,705)	(98,069)
Net Interest Income	128,115	71,511	46,470
Operating expenses	(36,895)	(20,005)	(12,747)
Net unrealized and realized market value gains	46,676	5,111	1,532
Net income before provision for income taxes	137,896	56,617	35,255
Provision for income taxes	(5,502)	—	—
Net Income before change in accounting principle	132,394	56,617	35,255
Cumulative effect of adopting EITF 99-20	—	—	(2,368)
Net Income	132,394	56,617	32,887
Dividends on Class B preferred stock	(681)	(2,724)	(2,724)
Net Income Available to Common Stockholders	$ 131,713	$ 53,893	$ 30,163
Earnings Per Share:			
Basic Earnings Per Share:			
Net income before change in accounting principle	$ 7.42	$ 3.55	$ 3.20
Cumulative effect of adopting EITF 99-20	—	—	(0.23)
Net income available to common stockholders	$ 7.42	$ 3.55	$ 2.97
Diluted Earnings Per Share:			
Net income before change in accounting principle	$ 7.09	$ 3.44	$ 3.11
Cumulative effect of adopting EITF 99-20	—	—	(0.23)
Net income available to common stockholders	$ 7.09	$ 3.44	$ 2.88
Dividends declared per common share	$ 7.350	$ 2.885	$ 2.550
Dividends declared per preferred share	$ 0.755	$ 3.020	$ 3.020
Weighted average shares of common stock and common stock equivalents:			
Basic	17,759,346	15,177,449	10,163,581
Diluted	18,586,649	15,658,623	10,474,764

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Year Ended December 31,		
	2003	2002	2001
Net income available to common stockholders before preferred dividend	$132,394	$ 56,617	$32,887
Other comprehensive income:			
Net unrealized gains (losses) on available-for-sale securities	45,992	69,417	(743)
Reclassification adjustment for net (gains) losses included in net income	(35,621)	110	3,533
Net unrealized gains (losses) on cash flow hedges	532	(3,082)	—
Reclassification of net realized cash flow hedge losses to long-term interest expense	2,130	—	—
Other comprehensive income	13,033	66,445	2,790
Comprehensive income before preferred dividend	145,427	123,062	35,677
Dividends on Class B preferred stock	(681)	(2,724)	(2,724)
Comprehensive Income	$144,746	$120,338	$32,953

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands, except share data)

	Class B Preferred Stock		Common Stock		Additional Paid-in Capital	Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
	Shares	Amount	Shares	Amount					
December 31, 2000	902,068	$ 26,517	8,809,500	$ 88	$ 242,522	$ (89)	$ 27,074	$(80,448)	$ 215,664
Comprehensive income:									
Net income	—	—	—	—	—	—	32,887	—	32,887
Reclassification adjustment due to adoption Of EITF 99-20	—	—	—	—	—	2,368	—	—	2,368
Net unrealized gain on assets Available-for-sale	—	—	—	—	—	422	—	—	422
Total comprehensive income before preferred dividend									35,677
Issuance of common stock	—	—	3,852,249	39	86,146	—	—	—	86,185
Dividends declared:									
Preferred	—	—	—	—	—	—	—	(2,724)	(2,724)
Common	—	—	—	—	—	—	—	(27,029)	(27,029)
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	—	—	—	—	—	—	56,617	—	56,617
Net unrealized gain on assets Available-for-sale	—	—	—	—	—	69,527	—	—	69,527
Net unrealized loss on interest rate agreements	—	—	—	—	—	(3,082)	—	—	(3,082)
Total comprehensive income before preferred dividend									123,062
Issuance of common stock	—	—	3,615,536	36	90,033	—	—	—	90,069
Dividends declared:									
Preferred	—	—	—	—	—	—	—	(2,724)	(2,724)
Common	—	—	—	—	—	—	—	(45,147)	(45,147)
December 31, 2002	902,068	$ 26,517	16,277,285	$ 163	$ 418,701	$ 69,146	$ 116,578	$(158,072)	$ 473,033
Comprehensive income:									
Net income	—	—	—	—	—	—	132,394	—	132,394
Net unrealized loss on assets Available-for-sale	—	—	—	—	—	10,371	—	—	10,371
Net unrealized gain on interest rate agreements	—	—	—	—	—	2,662	—	—	2,662
Total comprehensive income before preferred dividend									145,427
Issuance of common stock	—	—	1,883,630	19	72,617	—	—	—	72,636
Conversion of preferred stock	(902,068)	(26,517)	902,068	9	26,508	—	—	—	—
Dividends declared:									
Preferred	—	—	—	—	—	—	—	(681)	(681)
Common	—	—	—	—	—	—	—	(137,087)	(137,087)
December 31, 2003	—	$ —	19,062,983	$ 191	$ 517,826	$ 82,179	$ 248,972	$(295,840)	$ 553,328

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years Ended December 31, 2003	2002	2001
Cash Flows From Operating Activities:			
Net income available to common stockholders before preferred dividend	$ 132,394	$ 56,617	$ 32,887
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Amortization	(12,375)	9,960	11,226
Provision for credit losses	8,646	3,308	768
Non-cash stock compensation	457	159	401
Net unrealized and realized market value gains	(46,676)	(5,111)	(1,532)
Cumulative effect of adopting EITF 99-20	—	—	2,368
Net sales (purchases) of real estate loans held-for-sale	1,379	(1,558,104)	(672,192)
Principal payments on real estate loans held-for-sale	440	14,876	11,384
Net sales (purchases) of real estate securities trading	—	278,369	(61,294)
Principal payments on real estate securities trading	—	135,875	302,176
Net purchases of interest rate agreements	(2,921)	(3,609)	(664)
Net change in:			
Accrued interest receivable	(20,619)	(5,358)	2,068
Principal receivable	(12,529)	6,609	163
Other assets	(1,987)	(3,232)	1,046
Accrued interest payable	11,289	2,698	(3,088)
Accrued expenses and other liabilities	11,740	9,531	2,318
Net cash provided by (used in) operating activities	69,238	(1,057,412)	(371,966)
Cash Flows From Investing Activities:			
Purchases of real estate loans held-for-investment	(11,407,808)	(3,694,188)	—
Proceeds from sales of real estate loans held-for-investment	73,137	44,811	4,313
Principal payments on real estate loans held-for-investment	1,277,615	459,256	330,178
Purchases of real estate securities available-for-sale	(714,633)	(386,444)	(313,757)
Proceeds from sales of real estate securities available-for-sale	5,299	145,268	33,070
Principal payments on real estate securities available-for-sale	269,986	95,703	10,534
Net (increase) decrease in restricted cash	(10,202)	(8,356)	1,841
Net cash (used in) provided by investing activities	(10,506,606)	(3,343,950)	66,179
Cash Flows From Financing Activities:			
Net borrowings (repayments) on short-term debt	136,723	(697,097)	22,389
Proceeds from issuance of long-term debt	11,859,420	5,593,172	525,190
Repayments on long-term debt	(1,467,929)	(511,258)	(307,999)
Net proceeds from issuance of common stock	66,800	89,863	85,785
Dividends paid	(138,348)	(43,179)	(26,031)
Net cash provided by financing activities	10,456,666	4,431,501	299,334
Net increase (decrease) in cash and cash equivalents	19,298	30,139	(6,453)
Cash and cash equivalents at beginning of period	39,169	9,030	15,483
Cash and cash equivalents at end of period	$ 58,467	$ 39,169	$ 9,030
Supplemental disclosure of cash flow information:			
Cash paid for interest	$ 191,572	$ 89,007	$ 100,919
Cash paid for taxes	$ 7,006	$ —	$ —
Non-cash financing activity:			
Dividends declared but not paid	$ 12,391	$ 12,970	$ 8,278

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2003

NOTE 1. REDWOOD TRUST

Redwood Trust, Inc. (Redwood Trust) together with its subsidiaries is an investor in real estate loans. Our primary business is owning and credit enhancing high-quality jumbo residential real estate loans nationwide. We also invest in diverse types of real estate loans through our residential and commercial real estate securities portfolio and our commercial real estate loan portfolio. Our primary source of revenue is monthly loan payments made by homeowners and property owners on their loans, and our primary expense is the cost of borrowed funds. Redwood Trust is structured as a Real Estate Investment Trust (REIT) and therefore the majority of our taxable income (exclusive of income earned in taxable subsidiaries) is distributed to shareholders as dividends.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation
The December 31, 2003 and 2002 consolidated financial statements include the accounts of Redwood Trust and its wholly-owned subsidiaries, Sequoia Mortgage Funding Corporation, Acacia CDO 1 LTD, Acacia CDO 2 LTD, Acacia CDO 3 LTD, and RWT Holdings, Inc. (Holdings), and Holdings' wholly-owned subsidiaries including Sequoia Residential Funding, Inc. For financial reporting purposes, references to Sequoia mean Sequoia Mortgage Funding Corporation and Sequoia Residential Funding, Inc. References to Acacia mean Acacia CDO 1, LTD, Acacia CDO 2, LTD, and Acacia CDO 3, LTD. References to the REIT mean Redwood Trust exclusive of its taxable subsidiaries.

Substantially all of the assets of Sequoia, consisting primarily of residential real estate loans as part of residential real estate loans on our Consolidated Balance Sheets, are pledged to support long-term debt in the form of collateralized mortgage-backed securities. Substantially all of the assets of Acacia, consisting primarily of residential and commercial real estate loan securities and other asset-backed securities included in our residential loan credit-enhancement securities and securities portfolio, are pledged to support long-term debt in the form of collateralized asset-backed securities. The assets of Sequoia and Acacia are not available for the satisfaction of general claims of Redwood Trust. Our exposure to loss on the assets, which are collateral for long-term debt, is limited to our net equity investment in Sequoia and Acacia, as the long-term debt is non-recourse to Redwood Trust.

All significant intercompany balances and transactions with Sequoia, Acacia, and Holdings have been eliminated in the consolidation of Redwood Trust as of December 31, 2003 and 2002. Certain amounts for prior periods have been reclassified to conform to the December 31, 2003 and 2002 presentation.

Use of Estimates
The preparation of financial statements in conformity with Generally Accepted Accounting Principles (GAAP) requires us to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. Our estimates are inherently subjective in nature and actual results could differ from those estimates. The primary estimates inherent in the accompanying consolidated financial statements are discussed below.

Fair Value. We estimate the fair value of our financial instruments using available market information and other appropriate valuation methodologies. Where applicable, certain fair value estimates made by management are validated against prices provided by certain dealers who make a market in these financial instruments. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced liquidation sale. Our 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*.

Reserves for Credit Losses. We establish and maintain credit reserves for estimated credit losses in our residential and commercial held-for-investment real estate loan portfolios. The reserves consist of a component for individual loan impairment and one or more components of collective impairment. Impairment exists when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. The credit reserves are based upon our assessment of various factors affecting the credit quality of our assets. The reserves are reviewed on a regular basis and adjusted as deemed necessary. The reserve for credit losses on our real estate loans is established by taking credit provisions through our Consolidated Statements of Income. Summary information regarding the reserve for credit losses on real estate loans is presented in *Note 4*. In addition to reserves for credit losses established for our real estate loan portfolios, we also estimate credit protection levels for certain assets purchased at discounts related to credit quality. Our residential loan credit-enhancement securities represent subordinated interests in pools of high-quality jumbo residential real estate loans. These securities are generally rated below investment-grade and, as a result, are typically purchased at a deep discount. A portion of the purchase discount is considered a designated form of credit protection while the remaining component of the purchase discount is accreted as interest income under the effective yield method.

Recognition of Interest Income and Impairment on Investments in Beneficial Interests. Our investment in residential loan credit-enhancement securities and certain investments in our securities portfolio are investments in beneficial interests. We generally purchase these assets at discounts and accrete the discounts into income using the effective yield method — a method that estimates a constant effective yield over the effective life of each security. To apply the effective yield method we calculate a yield of each beneficial interest by estimating the cash flows attributable to each beneficial interest. If the estimated future cash flows change, then we recalculate the yield and adjust the periodic accretion recognized as income prospectively. In addition, if a decline in cash flows is not from a temporary condition and the fair value of the beneficial interest declines to below its carrying amount, we record a mark-to-market loss under net unrealized and realized market value gains on our Consolidated Statements of Income. Beneficial interests are included as part of our securities available-for-sale on our Consolidated Balance Sheets.

The provisions of Emerging Issues Task Force 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20) became effective January 1, 2001. At that date, the Company's projections of cash flows on certain of its residential credit-enhancement securities 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 Consolidated Statements of Income at that time as a cumulative effect of a change in accounting principle.

Risks and Uncertainties
We take certain risks inherent in financial institutions including, but not limited to, credit risk, liquidity risk, interest rate risk, prepayment risk, market value risk, reinvestment risk, and capital risk. In addition, there are several risks and uncertainties specific to our business. We seek to actively manage such risks while also providing our stockholders an appropriate rate of return for risks taken. There can be no assurances that such risks and uncertainties are adequately provided for in our financial statements.

A significant portion of our liabilities represents non-recourse long-term debt; our measure of long-term debt consists entirely of mortgage-backed securities issued by bankruptcy-remote securitization trusts. The owners of these securities have no recourse to us and must look only to the assets of the securitization trust for repayment.

Earning Assets
Our earning assets consist primarily of residential and commercial real estate loans and securities. Real estate 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 our opinion, it is collectible. Purchase discounts and premiums relating to earning assets are amortized into interest income over their estimated lives considering the prepayments of the earning assets using the effective yield method. Gains or losses on the sale of earning assets are based on the specific identification method.

Residential and Commercial Real Estate Loans: Held-for-Investment
Real estate 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 our Sequoia loans that are pledged or subordinated to support our long-term debt are classified as held-for-investment. Commercial real estate loans for which we have secured financing through the term of the loan or we otherwise have the intent and the ability to hold to maturity are classified as held-for-investment. While we generally do not sell real estate loans as part of our normal business operations, real estate loans classified as held-for-investment may be sold from time to time, especially subsequent to a call of Sequoia long-term debt.

Residential and Commercial Real Estate Loans: Held-for-Sale
Real estate loans held-for-sale (residential and commercial) are carried at the lower of original cost or market value. Any lower of cost or market adjustments on these loans are recognized in net unrealized and realized market value gains on our Consolidated Statements of Income. Real estate owned (REO) assets are included in real estate loans held-for-sale.

Securities: Available-for-Sale
Securities available-for-sale are carried at their estimated fair value. Cumulative unrealized gains and losses are classified as accumulated other comprehensive income in Stockholders' Equity. Unrealized losses on these securities are reported as a component of net unrealized and realized market value gains in our Consolidated Statements of Income if the decline in value is considered to represent a permanent impairment.

Securities: Trading
Securities classified as trading are recorded at their estimated fair market value. Unrealized gains and losses on these securities are recognized as a component of net unrealized and realized market value gains on our Consolidated Statements of Income.

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 may include principal and interest payments on real estate loans or securities held as collateral for long-term debt, cash pledged as collateral on certain interest rate agreements, and cash held from borrowers until certain loan agreement requirements have been met. Any corresponding liability for cash held from borrowers is included in accrued expenses and other liabilities on our Consolidated Balance Sheets.

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

Interest Rate Agreements
We maintain an overall interest rate risk management strategy that incorporates the use of derivative interest rate agreements for a variety of reasons, including minimizing significant fluctuations in earnings or market values on certain assets or liabilities that may be caused by interest rate volatility. Interest rate agreements we use as part of our interest rate risk management strategy may include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchases (collectively referred to as interest rate agreements). On the date an interest rate agreement is entered into, we designate 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).

Prior to the fourth quarter of 2002, we elected not to seek hedge accounting treatment for any of our interest rate agreements. Therefore, hedges were designated as trading and were 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 on our Consolidated Statements of Income. Beginning in the fourth quarter of 2002, we elected hedge accounting treatment for certain of our interest rate agreements. Accordingly, specific instruments are accounted for as cash flow hedges, are recorded at their estimated fair market value, and changes in their fair value are generally reported in accumulated other comprehensive income on our Consolidated Balance Sheets. The income or expense related to interest rate agreements is recognized on an accrual basis and is included in interest expense in our Consolidated Statements of Income. Any ineffective portions of the cash flow hedges are included in our Consolidated Statements of Income (see *Note 5*).

We formally document all relationships between hedging instruments and hedged items, as well as our risk-management objective and strategy for undertaking various hedge transactions. This process includes identifying all derivatives that are designated as fair value or cash flow hedges to (1) specific assets and liabilities on our Consolidated Balance Sheets or (2) specific firm commitments or forecasted transactions. We also formally assess (both at the hedge's inception and on an ongoing basis) whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in the fair value or cash flows of hedged items and whether those derivatives may be expected to remain highly effective in future periods.

We discontinue hedge accounting prospectively when (1) we determine that the derivative is no longer effective in offsetting changes in the fair value or cash flows of a hedged item (including hedged items such as firm commitments or forecasted transactions); (2) it is no longer probable that the forecasted transaction will occur; (3) a hedged firm commitment no longer meets the definition of a firm commitment; or (4) we determine that designating the derivative as a hedging instrument is no longer appropriate.

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 bond issuance costs. The amortization of any discount or premium is recognized as an adjustment to interest expense using the effective yield method based on the repayment 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 related securitized assets using the effective yield method, adjusted for the effects of actual principal paydown rates.

Taxes
We have 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, we must distribute at least 90% of our annual REIT taxable income (exclusive of undistributed taxable income of taxable subsidiaries) to stockholders within the time frame set forth in the tax rules and meet certain other requirements. If these requirements are met, we generally will not be subject to Federal or state income taxation at the corporate level with respect to the REIT taxable income we distribute to our stockholders. In 2003, we retained approximately 10% of our ordinary REIT taxable income and paid corporate income taxes on this retained income while continuing to maintain our REIT status. Accordingly, we have recorded a provision for income taxes based upon our estimated current liability for Federal and state income tax purposes in our Consolidated Statements of Income. In prior years, no income tax provision was necessary at the REIT as we distributed 100% of our REIT taxable income. Given our ability and historical practice (through 2002) to distribute 100% of our REIT taxable income, no provision for deferred taxes has been recorded as there is no assurance that there will be taxable income available in future periods to realize net deductible temporary differences.

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 REIT 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 REIT taxable income on the record date. Therefore, the regular dividends declared in the fourth quarter of 2003, which were paid in January 2004, are considered taxable income to stockholders in 2003 (the year declared).

The taxable income of Holdings and its subsidiaries is not included in REIT taxable income and is subject to state and Federal income taxes at the applicable statutory rates. Holdings provides for any deferred income taxes to reflect estimated future tax effects. Deferred income taxes, to the extent they exist, reflect 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. See *Note 8* for further discussion on income taxes at Holdings.

To the extent a REIT's distributions declared before calendar year-end and paid on or before January 31 of the following calendar year are less than 85% of its REIT taxable income in the calendar year plus 100% of the undistributed REIT taxable income from prior calendar years, a REIT incurs a 4% excise tax on the shortfall. Given our current plans for the timing of the distribution of year 2003 REIT taxable income in 2004, our dividend distributions declared before calendar year-end and distributed on or before January 31, 2004 were less than 85% of REIT taxable income for the 2003 calendar year and the prior year's undistributed REIT taxable income. Therefore, we incurred a 4% excise tax provision on the shortfall. Accordingly, we have made a provision for excise tax in our Consolidated Statements of Income (See *Note 8*).

Net Income Per Share

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

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The following table provides reconciliation of the numerators and denominators of the basic and diluted net income per share computations.

(in thousands, except share data)	Years Ended December 31, 2003	2002	2001
Numerator:			
Numerator for basic and diluted earnings per share:			
Net income before Change in accounting principle	$ 132,394	$ 56,617	$ 35,255
Cash dividends on Class B preferred stock	(681)	(2,724)	(2,724)
Net income before change in accounting principle	131,713	53,893	32,531
Cumulative effect of adopting EITF 99-20	—	—	(2,368)
Basic and Diluted EPS — Net income available to common stockholders	$ 131,713	$ 53,893	$ 30,163
Denominator:			
Denominator for basic earnings per share:			
Weighted average number of common shares outstanding during the period	17,759,346	15,177,449	10,163,581
Net effect of dilutive stock options	827,303	481,174	311,183
Denominator for diluted earnings per share	18,586,649	15,658,623	10,474,764
Basic Earnings Per Share:			
Net income before change in accounting principle	$ 7.42	$ 3.55	$ 3.20
Cumulative effect of adopting EITF 99-20	—	—	(0.23)
Net income per share	$ 7.42	$ 3.55	$ 2.97
Diluted Earnings Per Share:			
Net income before change in accounting principle	$ 7.09	$ 3.44	$ 3.11
Cumulative effect of adopting EITF 99-20	—	—	(0.23)
Net income per share	$ 7.09	$ 3.44	$ 2.88

For the years ended December 31, 2003, 2002 and 2001, the number of common equivalent shares issued by Redwood Trust that were anti-dilutive totaled 112,250, 406,816, and 412,001, respectively.

Comprehensive Income
Current period net unrealized gains and losses on assets available-for-sale and current period net unrealized gains and losses on interest rate agreements are reported as a component of comprehensive income on our Consolidated Statements of Stockholders' Equity with cumulative unrealized gains and losses classified as accumulated other comprehensive income in Stockholders' Equity. As of December 31, 2003 and 2002, accumulated other comprehensive income consisted of net unrealized gains and losses on both real estate loan securities available-for-sale and derivatives classified as cash flow hedges. In prior years, the only component of accumulated other comprehensive income was net unrealized gains and losses on real estate loan securities available-for-sale.

Stock-Based Compensation
As of December 31, 2003 and 2002, we had one stock-based employee compensation plan and one employee stock purchase plan, which are described more fully in *Note 10*. In the fourth quarter of 2003, we adopted, effective January 1, 2003, SFAS No. 123 *Accounting for Stock-Based Compensation* as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure — An Amendment of FASB Statement No. 123*. Through the adoption of this pronouncement, all stock-based compensation awards issued in 2003 and future awards are accounted for under the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation.*

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We continue to account for all stock-based compensation awards issued prior to 2003 under the recognition and measurement principles of APB Opinion No. 25*Accounting for Stock Issued to Employees,* and related interpretations. Under these provisions, when we grant stock-based compensation awards we do not include any stock-based employee compensation cost in net income as awards granted under the plan have an exercise price equal to the market value of the underlying common stock on the date of grant. In accordance with the disclosure requirements of SFAS No. 148, the following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation,* to all stock-based employee compensation awards.

(in thousands, except share data)	Year Ended December 31,		
	2003	2002	2001
Net income, as reported	$131,713	$53,893	$30,163
Add: Dividend equivalent right operating expenses under APB 25	12,392	7,248	3,436
Add: Variable stock option operating expenses under APB 25	5,651	665	911
Deduct: Stock-based employee compensation expense determined under fair value based method for all awards	(1,390)	(1,577)	(2,184)
Pro forma net income	$148,366	$60,229	$32,326
Earnings per share:			
Basic—as reported	$ 7.42	$ 3.55	$ 2.97
Basic—pro forma	$ 8.35	$ 3.97	$ 3.18
Diluted—as reported	$ 7.09	$ 3.44	$ 2.88
Diluted—pro forma	$ 7.98	$ 3.85	$ 3.09

For purposes of determining option fair values for use in the above table, the values are based on the Black-Scholes option pricing model as of the various grant dates using the following principal assumptions: expected option life of five years, expected stock price volatility of 22%, risk free rates of return based on the five-year Treasury rate at the date of grant, and a dividend yield of zero. The Company does not estimate future forfeitures when reporting option expense under SFAS No. 123. The Company adjusts future stock option expense once forfeitures occur. The actual value, if any, which the option recipient will realize from these options will depend solely on the increase in the stock price over the option price when the options are exercised.

Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46). In December 2003, FASB issued FIN No. 46R which replaced FIN 46 and clarified ARB 51. This interpretation provides guidance on how to identify a variable interest entity (VIE) and when a company should include in its financial statements the assets, liabilities, and activities of a VIE. Under FIN 46, a company must consolidate a VIE when it is considered to be its primary beneficiary. The primary beneficiary is the entity that will absorb a majority (50% or more) of the risk of expected losses and/or receive most of the expected residual benefit from taking on that risk.

Our principal business activity involves issuing various series of non-recourse long-term debt collateralized by residential and commercial real estate loans and mortgage-backed securities. The collateral specific to each long-term debt series is the sole source of repayment of the debt and, therefore, our exposure to loss is limited to our net investment in the collateral. Historically we have consolidated the assets, liabilities, and activities of these transactions under pre-existing GAAP. Under FIN 46, these interests may be deemed VIEs and we may be considered the primary beneficiary. Regardless, our involvement remains unchanged, as does our accounting treatment. In addition, we consolidate our interest in a warehouse agreement where we are acquiring assets prior to securitization. We disclose our interests in VIEs under FIN 46 throughout these financial statements and footnotes.

In April 2003, the FASB issued SFAS No. 149,*Amendment of Statement 133 on Derivative Instruments and Hedging Activities*(FAS 149). This statement provides for more consistent financial reporting by requiring contracts with comparable characteristics to be accounted for similarly with respect to the scope of SFAS 133. This statement provides guidance on when a contract with an initial net investment meets the characteristics of a derivative and when a derivative contains a financing component. This statement is effective for contracts entered into or modified after June 30, 2003 and applies to certain purchase commitments, including contractual commitments to purchase loans. As of December 31, 2003, we had outstanding commitments to purchase adjustable-rate residential real estate loans. These purchase commitments were settled in January 2004 and we did not incur any net unrealized gains (losses) on these purchase commitments with respect to FAS 149.

In May 2003, the FASB issued SFAS No. 150,*Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*(FAS 150). This statement requires the issuers of financial instruments to classify certain instruments as liabilities that have characteristics of both liabilities and equity. Instruments subject to FAS 150 include mandatorily redeemable shares and instruments that embody an obligation to repurchase an issuer's equity shares and that may require the issuer to settle the obligation through the transfer of assets. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. On November 7, 2003, the FASB deferred, for an indefinite period, certain provisions of FAS 150 relating to the classification and measurement of mandatorily redeemable non-controlling interests. We believe we do not have any such interests. The remaining provisions of SFAS 150 did not impact our financial position or results of operations.

NOTE 3. EARNING ASSETS

As of December 31, 2003 and 2002, our earning assets generally consisted of investments in adjustable-rate, hybrid, and fixed-rate residential and commercial real estate loans and securities. Hybrid loans have an initial fixed coupon rate for three to ten years followed by periodic (usually annual) adjustments. The original maturity of the majority of our residential real estate loans and residential and commercial real estate securities is twenty-five to thirty years. The original maturity of our commercial real estate loans is from two to ten years. The actual amount of principal outstanding is subject to change based on the prepayments of the underlying loans.

For the years ended December 31, 2003, 2002, and 2001 the average balance of earning assets was $10.9 billion, $3.9 billion, and $2.2 billion, respectively.

As of December 31, 2003 and 2002, earning assets consisted of the following:

Residential Real Estate Loans

	December 31, 2003			December 31, 2002		
(in thousands)	**Held-for-Sale**	**Held-for-Investment**	**Total**	**Held-for-Sale**	**Held-for-Investment**	**Total**
Current Face	$ —	$ 16,110,748	$16,110,748	$ 918	$ 6,189,756	$6,190,674
Unamortized Discount	—	—	—	(13)	—	(13)
Unamortized Premium	—	144,748	144,748	1	32,788	32,789
Amortized Cost	—	16,255,496	16,255,496	906	6,222,544	6,223,450
Reserve for Credit Losses	—	(16,336)	(16,336)	—	(8,271)	(8,271)
Carrying Value	$ —	$ 16,239,160	$16,239,160	$ 906	$ 6,214,273	$6,215,179

We acquire residential real estate loans from third party originators for securitization under the Sequoia program. These loans are transferred to securitization trusts and are the primary source of collateral for the non-recourse long-term debt on our Consolidated Balance Sheets. For the years ended December 31, 2003, 2002, and 2001, we acquired $11.4 billion, $5.3 billion and $0.7 billion, respectively, of residential real estate loans in pools and bulk purchase transactions. Principal paydowns on our residential real estate loans for the years ended December 31, 2003, 2002, and 2001 totaled $1.3 billion, $0.5 billion and $0.3 billion, respectively. As of December 31, 2003 and 2002, unsecuritized residential real estate loans with a net carrying value of $43 million and $103 million, respectively, were pledged as collateral under short-term borrowing arrangements to third parties. These assets are financed with short-term borrowings prior to securitization through our Sequoia program. As of December 31, 2003 and 2002, residential real estate loans with a net carrying value of $16.2 billion and $6.2 billion, respectively, were pledged as collateral for long-term debt through our Sequoia program.

The following tables provide detail on the Company's Residential Real Estate Loans at December 31, 2003 and 2002.

				December 31, 2003 (all dollars in thousands)		
Loan Description/Type	Interest Rate Index	Interest Rate	Maturity Date	Current Face	Carrying Value	Delinquent Face
1st Lien Adjustable Rate Residential Real Estate Loans	1 Month LIBOR	1.13% – 4.13%	2021-2033	$ 3,761,860	$ 3,791,844	$ 1,734
1st Lien Adjustable Rate Residential Real Estate Loans	6 Month LIBOR	1.13% – 4.75%	2016-2033	12,311,834	12,409,966	3,685
1st Lien Adjustable Rate Residential Real Estate Loans	3 Year Hybrid/6 Month LIBOR	4.75% – 6.5%	2031-2032	37,054	37,350	—
				$ 16,110,748	$ 16,239,160	$ 5,419

				December 31, 2002 (all dollars in thousands)		
Loan Description/Type	Interest Rate Index	Interest Rate	Maturity Date	Current Face	Carrying Value	Delinquent Face
1st Lien Adjustable Rate Residential Real Estate Loans	1 Month LIBOR	1.6% – 5.0%	2016-2035	$ 1,737,979	$ 1,744,859	$ 991
1st Lien Adjustable Rate Residential Real Estate Loans	6 Month LIBOR	1.6% – 5.5%	2016-2035	4,283,178	4,300,132	2,196
1st Lien Adjustable Rate Residential Real Estate Loans	1 Year CMT	4.0% – 7.8%	2016-2030	79,309	79,623	940
1st Lien Adjustable Rate Residential Real Estate Loans	3 Year Hybrid/6 Month LIBOR	4.5% – 6.5%	2031-2035	90,208	90,565	—
				$ 6,190,674	$ 6,215,179	$ 4,127

The following table provides detail of the activity of the Company's Residential Real Estate Loan portfolio for the years ended December 31, 2003 and 2002.

(in thousands)	2003	2002
Residential Real Estate Loans at beginning of year	$ 6,215,179	$1,474,862
Acquisitions	11,401,367	5,255,593
Sales Proceeds	(73,742)	(49,643)
Principal Payments	(1,266,702)	(451,317)
Amortization Premium	(29,615)	(11,988)
Credit Provisions	(8,146)	(3,308)
Net Charge-Offs	81	236
Net unrealized and realized market value gains	738	744
Residential Real Estate Loans at end of year	$16,239,160	$6,215,179

As of December 31, 2003 and 2002, the Company's Residential Real Estate Loans were located in the following areas in the United States.

Geographic Concentration	December 31, 2003	December 31, 2002
Northern California	13%	13%
Southern California	12%	12%
Florida	11%	11%
New York	6%	6%
Georgia	5%	6%
New Jersey	5%	5%
Illinois	4%	4%
Texas	4%	4%
Arizona	4%	3%
Colorado	4%	3%
North Carolina	3%	3%
Other States (none greater than 3%)	29%	30%
Total	100%	100%

Residential Loan Credit-Enhancement Securities

(in thousands)	December 31, 2003 Securities Available-for-Sale	December 31, 2002 Securities Available-for-Sale
Current Face	$ 623,692	$ 559,186
Unamortized Discount	(123,329)	(58,578)
Portion Of Discount Designated As A Credit Reserve	(200,970)	(224,891)
Amortized Cost	299,393	275,717
Gross Unrealized Gains	83,993	79,867
Gross Unrealized Losses	(4,659)	(3,105)
Carrying Value	$ 378,727	$ 352,479

We credit enhance pools of high-quality jumbo residential real estate 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 loans, thus allowing the more senior securitized interests to qualify for investment-grade ratings and to be sold in the capital markets. We therefore commit capital that partially "credit enhances" a securitized pool of residential real estate loans. For the years ended December 31, 2003, 2002, and 2001, we acquired $149 million, $127 million and $126 million, respectively, in carrying value of residential loan credit-enhancement securities. Principal paydowns for the years ended December 31, 2003, 2002 and 2001 totaled $216 million, $43 million and $9 million, respectively. Of the $216 million of principal paydowns in 2003, $117 million represented calls of the security issues in accordance with the original issue provisions of the individual securitization trusts.

Our residential loan 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 within each specific residential loan credit-enhancement security 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 our second and third loss securities provide our interests with some protection from losses, as they serve as external credit enhancement. Our residential loan credit-enhancement securities provided some level of credit enhancement on $68 billion and $59 billion of residential real estate loans securitized by third parties as of December 31, 2003 and 2002, respectively.

When we purchase residential loan credit-enhancement securities, 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 using the effective yield method based on projected cash flows over the life of the security. Yields on each security vary as a function of credit results, prepayment rates, and interest rates. The designated credit protection is specific to each residential loan credit-enhancement security. If estimated future credit losses exceed our prior 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 downward or we may take a mark-to-market earnings charge to write down our investment in the security to current market value to reflect permanent impairment. If estimated future credit losses are less than our prior 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. For the years ended December 31, 2003, 2002, and 2001 we recognized market value losses of $1.5 million, $1.2 million, and $2.4 million, respectively, on our Consolidated Statements of Income from our residential loan credit-enhancement securities to reflect permanent impairment.

Our residential loan credit-enhancement securities are classified as available-for-sale and are carried at their estimated fair value. Gross unrealized gains and losses represent the differences between the net amortized cost and the fair value of the individual securities. At December 31, 2003 and 2002, gross unrealized gains were $84.0 million and $80.0 million, respectively. At December 31, 2003 and 2002, gross unrealized losses were $4.7 million and $3.1 million, respectively. The gross unrealized losses at December 31, 2003 and 2002 represented temporary declines in market value that were not considered to be permanent. Of the gross unrealized losses of $3.1 million at December 31, 2002, $1.3 million was recognized as permanent impairment on the Consolidated Statements of Income in 2003. Gross unrealized gains and losses are a component of accumulated other comprehensive income on our Consolidated Balance Sheets.

As of December 31, 2003, $39 million of residential loan credit-enhancement securities were pledged as collateral under short-term borrowing arrangements to third parties. At December 31, 2002, no residential loan credit-enhancement securities were pledged as collateral under short-term borrowing arrangements to third parties. As of December 31, 2003 and 2002, residential loan credit-enhancement securities with a net carrying value of $128 million and $167 million, respectively, were pledged as collateral under long-term securitizations (see *Note 7*).

Commercial Real Estate Loans

	December 31, 2003			December 31, 2002		
(in thousands)	**Held-for-Sale**	**Held-for-Investment**	**Total**	**Held-for-Sale**	**Held-for-Investment**	**Total**
Current Face	$ 8,527	$ 22,653	$31,180	$ 19,139	$ 11,111	$30,250
Unamortized Discount	(721)	(7,540)	(8,261)	(897)	(83)	(980)
Reserve for Credit Losses	—	(500)	(500)	—	—	—
Carrying Value	$ 7,806	$ 14,613	$22,419	$ 18,242	$ 11,028	$29,270

Commercial real estate loans represent first lien interests in multifamily, office, retail, and industrial properties. Commercial real estate loans held-for-investment represent junior participations in first lien interests where we provide credit enhancement to a senior interest. Commercial real estate loans held-for-sale represent first lien interests in commercial properties where we have sole interest. For the years ended December 31, 2003 and 2002, we acquired $6.4 million and $1.5 million, respectively, of commercial real estate loans. Principal paydowns for the years ended December 31, 2003 and 2002 were $12 million and $23 million, respectively. As of December 31, 2003 and 2002, no commercial real estate loans were pledged as collateral under short-term borrowing arrangements to third parties. During the fourth quarter of 2003, we established a credit reserve on a commercial loan classified as held-for-investment for $500,000 due to vacancies at the underlying property. As of December 31, 2003 and 2002, commercial real estate loans held-for-investment with a net carrying value of $9 million and $10 million, respectively, were pledged as collateral under long-term borrowing arrangements to third parties (see *Note 7*).

The following tables provide detail on the Company's Commercial Real Estate Loans as of December 31, 2003 and 2002.

				December 31, 2003 (all dollars in thousands)		
Loan Description/Type	**Interest Rate Index**	**Interest Rate**	**Maturity Date**	**Current Face**	**Carrying Value**	**Delinquent Face**
1st Lien Adjustable Rate Commercial Real Estate Loans	1 Month LIBOR, with interest rate floor	7.00% — 9.25%	2004 - 2006	$ 5,651	$ 5,573	—
1st Lien Adjustable Rate Commercial Real Estate Loans	1 Month LIBOR	7.5%	2004	10,168	2,958	—
1st Lien Adjustable Rate Commercial Real Estate Loans	6 Month LIBOR, with interest rate floor	9.5% — 11%	2004 - 2009	15,361	13,888	—
				$ 31,180	$ 22,419	—

				December 31, 2002 (all dollars in thousands)		
Loan Description/Type	**Interest Rate Index**	**Interest Rate**	**Maturity Date**	**Current Face**	**Carrying Value**	**Delinquent Face**
1st Lien Adjustable Rate Commercial Real Estate Loans	1 Month LIBOR, with interest rate floor	9.3% — 10.8%	2003	$ 3,510	$ 3,098	$ 1,039
1st Lien Adjustable Rate Commercial Real Estate Loans	3 Month LIBOR, with interest rate floor	9.5%	2003	9,745	9,662	—
1st Lien Adjustable Rate Commercial Real Estate Loans	6 Month LIBOR, with interest rate floor	9.5%	2004	6,227	6,024	—
1st Lien Adjustable Rate Commercial Real Estate Loans	Hybrid/6 Month LIBOR	11%	2009	9,402	9,120	—
1st Lien Fixed Rate Commercial Real Estate Loans	Fixed	9.1% — 9.5%	2004	1,366	1,366	—
				$ 30,250	$ 29,270	$ 1,039

The following table provides detail of the activity of the Company's Commercial Real Estate Loan portfolio for the years ended December 31, 2003 and 2002.

(in thousands)	2003	2002
Commercial Real Estate Loans at beginning of year	$ 29,270	$ 51,084
Acquisitions	6,442	1,529
Principal Payments	(12,167)	(23,048)
Amortization Premium	(258)	52
Credit Provision	(500)	—
Net unrealized and realized market value losses	(368)	(347)
Commercial Real Estate Loans at end of year	$ 22,419	$ 29,270

As of December 31, 2003 and 2002, the Company's commercial real estate loans were located in the following areas in the United States.

Geographic Concentration	December 31, 2003	December 31, 2002
California	65%	36%
Kansas	24%	21%
Texas	11%	10%
New Jersey	—	33%
Total	100%	100%

Securities Portfolio

	December 31, 2003	December 31, 2002
(in thousands)	Securities Available-for-Sale	Securities Available-for-Sale
Current Face	$ 833,252	$ 339,095
Unamortized Discount	(16,946)	(5,385)
Unamortized Premium	25,142	6,523
Amortized Cost	841,448	340,233
Gross Unrealized Gains	9,420	1,520
Gross Unrealized Losses	(6,154)	(6,056)
Carrying Value	$ 844,714	$ 335,697

Securities portfolio assets represent investment-grade security interests in prime residential, sub-prime residential, commercial, second lien residential, and corporate REIT debt securities. For the years ended December 31, 2003 and 2002, acquisitions in our securities portfolio totaled $566 million and $303 million, respectively. Principal paydowns in our securities portfolio totaled $54 million and $188 million, respectively, for the years ended December 31, 2003 and 2002. For the year ended December 31, 2003, we incurred unrealized market value write downs of $6.1 million from our securities portfolio through our Consolidated Statements of Income. These write downs were primarily due to increased delinquencies of underlying manufactured housing loans and downgrades of underlying manufactured housing securities in this portfolio. For the years ended December 31, 2002 and 2001, we recognized net realized market value gains of $7.0 million and $1.8 million, respectively, from our securities portfolio through our Consolidated Statements of Income, primarily due to sales of securities in this portfolio.

Our securities portfolio securities are classified as available-for-sale and are carried at their estimated fair value. Gross unrealized gains and losses represent the differences between the net amortized cost and the fair value of the individual securities. At December 31, 2003 and 2002, gross unrealized gains were $9.4 million and $1.5 million, respectively. At both December 31, 2003 and 2002, gross unrealized losses were $6.1 million. The gross unrealized losses at December 31, 2003 and 2002 represented temporary declines in market value that were not considered to be permanent. Of the gross unrealized losses of $6.1 million at December 31, 2002, $1.6 million was recognized as permanent impairment on the

Consolidated Statements of Income in 2003 due to increased delinquencies of manufactured housing loans of underlying manufactured housing securities and credit rating downgrades of these securities. Gross unrealized gains and losses are a component of accumulated other comprehensive income on our Consolidated Balance Sheets.

As of December 31, 2003, securities portfolio assets with a net carrying value of $59 million were pledged as collateral under a warehouse agreement (see *Note 6*). As of December 31, 2002, no securities portfolio assets were pledged as collateral under a warehouse agreement. As of December 31, 2003 and December 31, 2002, securities portfolio assets with a net carrying value of $736 million and $285 million, respectively, were pledged as collateral under long-term securitizations (see *Note 7*).

NOTE 4. RESERVES FOR CREDIT LOSSES

We provide for credit losses on our residential and commercial real estate loans held-for-investment by maintaining reserves for credit losses. The reserves for credit losses are adjusted by taking provision for credit losses recorded as a reduction in interest income on residential and commercial real estate loans on our Consolidated Statements of Income. The reserves for credit losses are reflected as a component of residential and commercial real estate loans on our Consolidated Balance Sheets. The following table summarizes the activity in the reserves for credit losses.

Residential Real Estate Loans

	Year Ended December 31,		
(in thousands)	**2003**	**2002**	**2001**
Balance at beginning of period	$ 8,271	$5,199	$4,814
Provision for credit losses	8,146	3,308	767
Charge-offs	(81)	(236)	(382)
Balance at end of period	$16,336	$8,271	$5,199

Commercial Real Estate Loans

	Year Ended December 31,		
(in thousands)	**2003**	**2002**	**2001**
Balance at beginning of period	$ —	$ —	$ —
Provision for credit losses	500	—	—
Charge-offs	—	—	—
Balance at end of period	$ 500	$ —	$ —

We establish and maintain credit reserves that we believe represent probable credit losses that will result from impairment existing in our residential real estate loan portfolio as of the date of the financial statements. To calculate the reserve, we determine a level of impairment by first determining loss factors that can be specifically applied to each of our loan pools. We may consider various factors including, but not limited to, the age of our loans, underwriting standards, business climate, economic conditions, geographical considerations, past performance of similar loans, and other observable data. Once we determine applicable loss factors, we perform a migration analysis for each pool of loans and evaluate loss experience over their expected lives. We estimate the timing of these losses and then estimate the losses probable to occur over an effective loss confirmation period. This period is defined as the range of time between the probable occurrence of a credit loss (such as the initial deterioration of the borrower's financial condition) and the confirmation of that loss (the actual impairment or charge-off of the loan). The losses expected to occur within the effective loss confirmation period are the basis of our credit reserves. We reevaluate the level of our credit reserves on at least a quarterly basis and record provision, charge-offs, and recoveries monthly.

NOTE 5. INTEREST RATE AGREEMENTS

We generally attempt to structure our balance sheet to address many of the interest rate risks inherent in our assets and liabilities. We enter into certain interest rate agreements with the objective of matching the interest rate characteristics of our assets and liabilities.

We may enter into interest rate agreements consisting of interest rate options, interest rate swaps, interest rate futures, and other types of hedging instruments. We designate our interest rate agreements as trading instruments or cash flow hedges. In general, we use cash flow hedges to hedge our variable interest rate debt payments associated with certain existing and/or future liabilities.

Interest rate options, which include caps and call corridors (options), are agreements that transfer, modify, or reduce interest rate risk in exchange for the payment of a premium when a contract is initiated. Interest rate cap agreements provide cash flows to the extent that a specific interest rate index exceeds a fixed rate. Interest rate corridor agreements provide cash flows to us to the extent that a specific interest rate falls between two fixed rates.

Interest rate swaps (swaps) are agreements in which a series of cash flows are exchanged with a counterparty over a prescribed period based on fixed and indexed interest rates. The notional amount on which the interest payments are based is not exchanged. Most of our swaps involve the exchange of a floating interest payment for a fixed interest payment based on a periodically resetting index. Most of the swaps require that we provide collateral, such as securities or cash, to the counterparty when their fair values decrease significantly. Should the counterparty fail to return the collateral, we would be at risk for the fair market value of those assets pledged as collateral.

Interest rate futures are contracts for the delivery of securities or cash in which the seller agrees to deliver on a specified future date, a specified instrument or cash equivalent, at a specified price or yield. Under these agreements, if we have sold the futures, we will generally receive additional cash flows if interest rates rise. Conversely, we will generally pay additional cash flows if interest rates fall. The credit risk on futures is limited by the requirement that the exchange and its members make good on obligations of any member that fails to perform.

Prior to the fourth quarter of 2002, we treated all of our interest rate agreements as trading instruments and recorded any changes in fair values through net unrealized and realized market value gains on our Consolidated Statements of Income. Beginning with the fourth quarter of 2002, we elected hedge accounting treatment on certain interest rate agreements while continuing to account for other interest rate agreements as trading instruments. For the years ended December 31, 2003, 2002, and 2001, we recognized $0.4 million, $4.3 million and $0.4 million, respectively, of net market value losses on our interest rate agreements accounted for as trading instruments on our Consolidated Statements of Income.

We report our interest rate agreements at fair value. As of December 31, 2003 and 2002, the fair value of our interest rate agreements was negative $1.8 million and negative $4.0 million, respectively, and is included in both other assets and accrued expenses and other liabilities on our Consolidated Balance Sheets.

The following table shows the aggregate fair value of our interest rate agreements as of December 31, 2003 and 2002.

(in thousands)	December 31, 2003	December 31, 2002
Interest Rate Agreements Accounted for as Trading Instruments		
Interest Rate Caps Purchased	$ 855	$ —
Interest Rate Caps Sold	(855)	—
Interest Rate Corridors Purchased	170	—
Treasury Futures Sold	—	(16)
Interest Rate Agreements Accounted for as Cash Flow Hedges		
Interest Rate Corridors Purchased	—	21
Eurodollar Futures Sold	(164)	(276)
Interest Rate Swaps	(1,788)	(3,696)
Total Interest Rate Agreements	$ (1,782)	$ (3,967)

Changes in the fair value of our cash flow hedges are recorded in accumulated other comprehensive income on our Consolidated Balance Sheets and reclassified to our Consolidated Statements of Income over the effective hedge period. In the event the hedged transaction does not occur, we would immediately reclassify the entire balance related to the cash flow hedge from accumulated other comprehensive income to our Consolidated Statements of Income.

The following table depicts the balances in accumulated other comprehensive income as of December 31, 2003 and 2002 for our cash flow hedges. The $0.5 million of realized net losses included in other comprehensive income as of December 31, 2003 represents interest rate agreements designated as cash flow hedges that have expired or terminated. These realized net losses will be reclassified to interest expense in our Consolidated Statements of Income in 2004, the effective period for the hedged transactions. The $0.1 million of unrealized net gains as of December 31, 2003 and the $3.1 million of unrealized net losses as of December 31, 2002 included in other comprehensive income represent interest rate agreements designated as cash flow hedges that are currently outstanding.

	Consolidated Balance Sheets	
(in thousands)	Accumulated Other Comprehensive Income	
	December 31, 2003	December 31, 2002
Realized—Closed Transactions:		
Realized net (loss) remaining in accumulated other comprehensive income	$ (539)	$ —
Recognized but Unrealized—Open Transactions:		
Unrealized gain (loss) included in accumulated other comprehensive income	119	(3,082)
Total Accumulated Other Comprehensive Income on Interest Rate Agreements	$ (420)	$ (3,082)

As of December 31, 2003, certain of our interest rate agreements accounted for as cash flow hedges had expired or terminated and the effective period for the hedged transactions commenced. This caused a portion of our accumulated other comprehensive income to be reclassified to our Consolidated Statements of Income. For the year ended December 31, 2003, we reclassified $2.1 million of net losses from accumulated other comprehensive income on our Consolidated Balance Sheets to interest expense on long-term debt in our Consolidated Statements of Income. We did not have any cash flow hedges that expired or matured during the year ended December 31, 2002. Consequently, at December 31, 2002 there was no existing portion of the balance in accumulated other comprehensive income that was scheduled to be amortized into income or expense.

The following table depicts the activity for the years ended December 31, 2003 and 2002 for interest rate agreements accounted for as cash flow hedges. The realized net losses on closed transactions represent amounts reclassified from accumulated other comprehensive income to interest expense for the effective period on hedged transactions. The net ineffective portion of hedges represents amounts recorded in interest expense to the extent the open interest rate agreements are ineffective related to the hedged transaction.

	Consolidated Statements of Income			
(in thousands)	Year Ended December 31, 2003		Year Ended December 31, 2002	
	Interest Income (Expense)	Net Unrealized and Realized Market Value Gains (Losses)	Interest Income (Expense)	Net Unrealized and Realized Market Value Gains (Losses)
Realized — Closed Transactions:				
Realized net gain (loss) reclassified from other comprehensive income	$(2,057)	$ —	$ —	$ —
Unrealized — Open Transactions:				
Net ineffective portion of hedges	(233)	—	3	—

The following table summarizes the aggregate notional amounts of all of our interest rate agreements as well as the credit exposure related to these instruments as of December 31, 2003 and 2002. The credit exposure reflects the fair market value of any cash and collateral of Redwood Trust held by counterparties. Sequoia did not hold collateral of the third party financial institution for its swap as of December 31, 2003 or 2002. The cash and collateral held by counterparties are included in restricted cash on our Consolidated Balance Sheets.

	Notional Amounts		Credit Exposure	
(in thousands)	December 31, 2003	December 31, 2002	December 31, 2003	December 31, 2002
Interest Rate Caps Purchased	$ 65,000	$ 5,000	$ —	$ —
Interest Rate Caps Sold	(65,000)	—	—	—
Interest Rate Corridors Purchased	1,690,931	1,096,899	—	—
Eurodollar Futures Sold	(800,000)	(1,000,000)	804	876
Treasury Futures Sold	—	(1,200)	—	28
Interest Rate Swaps	7,186,657	525,971	3,360	6,600

In general, we incur 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, we may not receive the cash to which we would otherwise be entitled under the interest rate agreement. In order to mitigate this risk, we only enter into interest rate agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the U.S. Department of Treasury as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated BBB or higher. Furthermore, we generally enter into interest rate agreements with several different counterparties in order to diversify our credit risk exposure.

NOTE 6. SHORT-TERM DEBT

We enter into repurchase agreements, bank borrowings, and other forms of collateralized short-term borrowings (short-term debt) to finance a portion of our earning assets. We generally intend to use short-term debt only while we accumulate assets prior to issuing non-recourse long-term debt to finance real estate loan assets to maturity.

As of December 31, 2003, we had $236 million of short-term debt outstanding with a weighted-average borrowing rate of 1.98% and a weighted-average remaining maturity of 76 days. This debt was collateralized with $43 million of residential real estate loans and $226 million of securities. As of December 31, 2002, we had $100 million of short-term debt outstanding with a weighted-average borrowing rate of 1.94% and a weighted-average remaining maturity of 162 days. This debt was collateralized with $103 million of residential real estate loans.

As of December 31, 2003 and December 31, 2002, our short-term debt had the following remaining maturities:

(in thousands)	December 31, 2003	December 31, 2002
Within 30 days	$ 6,667	$ —
31 to 90 days	132,315	5,645
Over 90 days	97,455	94,069
Total Short-Term Debt	$ 236,437	$ 99,714

For the year ended December 31, 2003, the average balance of short-term debt was $0.4 billion with a weighted-average interest cost of 1.94%. For both the years ended December 31, 2002 and 2001, the average balance of short-term debt was $0.9 billion with a weighted-average interest cost of 2.37%, and 4.53%, respectively. The maximum balance outstanding for the years ended December 31, 2003, 2002, and 2001 was $0.8 billion, $1.4 billion, and $1.3 billion, respectively. Through December 31, 2003, we were in compliance with all of our debt covenants for all of our short-term borrowing arrangements and credit facilities.

We have uncommitted facilities available with several banks and Wall Street firms for financing residential real estate securities. As of December 31, 2003, we had borrowings under these facilities of $119 million. The collateral pledged under these borrowings are retained interests in previously issued adjustable-rate residential real estate loan securitizations through our Sequoia program and other retained interests. As of December 31, 2002, we did not have any borrowings under these uncommitted facilities. Borrowings under these facilities bear interest based on a specified margin over the one-month LIBOR interest rate. As of December 31, 2003, the weighted average borrowing rate under these facilities was 1.54%. It is our intention to renew committed and uncommitted facilities as needed, as well as pursue additional facilities and other types of financing.

As of both December 31, 2003 and 2002, we had short-term facilities with three Wall Street firms totaling $1.4 billion to fund residential real estate loans. Borrowings under these facilities bear interest based on a specified margin over the one-month LIBOR interest rate. As of December 31, 2003 and 2002, we had borrowings under these facilities of $39 million and $100 million, respectively, with weighted average borrowing rates of 1.65% and 1.94%, respectively. These facilities expire between April and October of 2004. We will likely seek to renew these facilities and may pursue additional facilities and do not anticipate any problems doing so at this time.

In November 2003, we entered into a warehouse agreement and an engagement letter with a bank designed to enable us to pursue the issuance of a collateralized debt obligation (CDO) through the Acacia program. As of December 31, 2003, we had borrowings under this agreement of $59 million. Borrowings under the warehouse agreement are non-recourse to Redwood and are secured by mortgage securities in our securities portfolio with a market value of $59 million at December 31, 2003. This agreement will be terminated upon the issuance of Acacia CDO 4, LTD in 2004.

As of December 31, 2003, we had several master repurchase agreements available to finance investment-grade securities. In addition, we had one facility with a Wall Street firm totaling $60 million for financing subordinated securities. At December 31, 2002, we had facilities for several investment-grade securities and for subordinated securities. We also had facilities with two banks and two Wall Street firms totaling $200 million. These facilities are intended to finance residential real estate loan securities with lower-than-investment-grade ratings. In addition to these committed facilities, we may also finance residential real estate loan securities with lower-than-investment-grade ratings through non-committed borrowing arrangements. As of December 31, 2003, borrowings under these committed and non-committed facilities totaled $20 million. As of December 31, 2002, we did not have any borrowings under these committed and non-committed facilities. Borrowings under these facilities bear interest based on a specified margin over the one-month LIBOR interest rate. During 2003, we chose not to renew three of these committed facilities. The termination date for the remaining committed facility is June 2004. We do not anticipate any problems renewing this credit facility but we may not seek renewal at its expiration.

NOTE 7. LONG-TERM DEBT

Through securitizations we issue long-term debt in the form of collateralized mortgage-backed securities. Each series of long-term debt consists of various classes at variable and fixed rates of interest. The maturity of each class is directly affected by the rate of principal prepayments on the related 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 long-term debt series is likely to occur earlier than its stated maturity.

Sequoia long-term debt is secured by residential real estate loans and residential real estate loan mortgage-backed securities (Sequoia bond collateral). The Sequoia bond collateral consists primarily of adjustable-rate and hybrid, conventional, 25- or 30-year residential real estate loans secured by first liens on one to four-family residential properties. All Sequoia bond collateral is pledged to secure repayment of the related Sequoia long-term debt obligation. During the years ended December 31, 2003 and 2002, we issued $11.3 billion and $5.1 billion, respectively, of Sequoia long-term debt to fund residential real estate loans. During the year ended December 31, 2003, we issued $70 million of Sequoia long-term debt secured by interest-only certificates which we had retained from prior Sequoia securitizations. During the year ended December 31, 2002, we issued $212 million of Sequoia long-term debt secured by residential real estate loan mortgage-backed securities.

Acacia long-term debt is secured by residential and commercial real estate loan mortgage-backed securities (Acacia bond collateral). All Acacia bond collateral is pledged to secure repayment of the related Acacia long-term debt obligation. During the years ended December 31, 2003 and 2002, we issued $563 million and $282 million, respectively, of Acacia long-term debt secured by residential and commercial real estate loan mortgage-backed securities and corporate REIT debt.

As of December 31, 2003, commercial long-term debt was secured by one hybrid commercial real estate loan (commercial loan collateral) with a maturity date in 2009, which was secured by a first lien on the related commercial real estate property reported on our Consolidated Balance Sheets as commercial real estate loans held-for-investment. As of December 31, 2002, commercial long-term debt was secured by one adjustable rate commercial real estate loan (commercial loan collateral) with a maturity date in 2003, which was secured by a first lien on the related commercial real estate property reported on our Consolidated Balance Sheets as commercial real estate loans held-for-investment.

Our exposure to loss on the Sequoia bond collateral, Acacia bond collateral, and the commercial loan collateral is limited to our net investment, as the residential and commercial long-term debt are non-recourse to Redwood Trust. As required by the governing documents related to each series of long-term debt, the Sequoia and Acacia bond collateral is held in the custody of trustees. Trustees collect principal and interest payments (less servicing and related fees) on the bond collateral and make corresponding principal and interest payments on the long-term debt. Obligations under our long-term debt are payable solely from the bond collateral and are otherwise non-recourse to Redwood Trust.

The components of the collateral for our long-term debt are summarized as follows:

(in thousands)	December 31, 2003	December 31, 2002
Residential Real Estate Loans:		
Residential Real Estate Loans held-for-sale	$ —	$ 174
Residential Real Estate Loans held-for-investment	16,195,702	6,065,582
Residential Loan Credit-Enhancement Securities available-for-sale	127,783	167,400
Securities Portfolio Securities available-for-sale	677,962	284,514
Restricted cash	16,669	3,118
Accrued interest receivable	35,960	15,845
Total Residential Long-Term Debt Collateral	17,054,076	6,536,633
Commercial Real Estate Loans held-for-investment	8,511	9,662
Total Long-Term Debt Collateral	$ 17,062,587	$ 6,546,295

The components of our long-term debt as of December 31, 2003 and 2002, along with other selected information are summarized below:

(in thousands)	December 31, 2003	December 31, 2002
Sequoia Long-Term Debt	$ 15,807,554	$ 6,119,720
Sequoia Long-Term Debt – Interest-Only Certificates	153,227	—
Acacia Long-Term Debt	847,474	285,000
Commercial Long-Term Debt	5,571	8,283
Unamortized premium on Long-Term Debt	12,376	5,184
Deferred bond issuance costs	(43,616)	(21,167)
Total Long-Term Debt	$ 16,782,586	$ 6,397,020
Range of weighted average interest rates, by series – Sequoia	1.45% to 5.74%	1.74% to 5.73%
Stated Sequoia maturities	2016–2039	2024–2039
Number of Sequoia series	25	13
Range of weighted average interest rates, by series – Acacia	2.00% to 2.09%	2.23%
Stated Acacia maturities	2018–2038	2018–2037
Number of Acacia series	3	1
Weighted average interest rates – Commercial	9.50%	8.63%
Stated commercial maturities	2009	2003
Number of commercial series	1	1

For the years ended December 31, 2003, 2002, and 2001, the average balance of Sequoia long-term debt was $9.6 billion, $2.7 billion, and $1.0 billion, respectively. As of December 31, 2003 and 2002, accrued interest payable on Sequoia long-term debt was $14.7 million and $4.6 million, respectively, and is reflected as a component of accrued interest payable on our Consolidated Balance Sheets. For the year ended December 31, 2003 the average balance of Acacia long-term debt was $0.5 billion. As of December 31, 2003 and 2002, accrued interest payable on Acacia long-term debt was $1.8 million and $0.4 million, respectively, and is reflected as a component of accrued interest payable on our Consolidated Balance Sheets. For years ended December 31, 2003, 2002, and 2001, the average balance of commercial long-term debt was $8 million, $24 million, and $13 million, respectively.

NOTE 8. TAXES

As a REIT, Redwood Trust can deduct dividends paid from REIT taxable income and thus, effectively, reduce or eliminate corporate-level income taxes. However, a REIT can retain up to 10% of its taxable income and still maintain its REIT status. We retained 10% of our 2003 REIT ordinary taxable income and were subject to corporate level income taxes on this retained income for the 2003 calendar tax year. Holdings, Redwood Trust's taxable subsidiary, is subject to corporate income taxes on 100% of its taxable income.

Our provision for corporate income taxes for Redwood Trust for the year December 31, 2003 was $4.8 million. For the years ended December 31, 2002 and 2001, we did not have a provision for corporate income taxes because we did not permanently retain any of our 2002 or 2001 REIT taxable income.

Our provision for income taxes for Holdings for the years ended December 31, 2003, 2002, and 2001 was $0.7 million, $0, and $3,200, respectively. California Revenue and Tax Code Section 24416.3 has caused the deduction for California net operating loss (NOL) carryforwards to be suspended for the tax years 2002 and 2003. In addition, this statute states that for any California carryforward of a NOL for which a deduction is denied by reason of the suspension, the carryforward period is extended for one year for losses sustained in taxable years in 2002, and two years for NOLs sustained in taxable years beginning before 2002. No additional Federal tax provision for Holdings was recorded for the years ended December 31, 2003, 2002, and 2001, as taxable income reported for these periods was offset by Federal net operating loss carryforwards from prior years.

Due to the uncertainty of realization of NOLs, no deferred tax benefit has been recorded for Holdings. A valuation allowance has been provided to offset the deferred tax assets related to the net operating loss carryforwards and other future temporary deductions as of December 31, 2003 and 2002. As of December 31, 2003 and 2002, Holdings had net operating loss carryforwards of approximately $16.8 million and $24.4 million for Federal tax purposes, respectively. As of both December 31, 2003 and 2002, Holdings had net operating loss carryforwards of approximately $15.8 million for state tax purposes. The Federal loss carryforwards and a portion of the state loss carryforwards expire between 2018 and 2021, while most of the state loss carryforwards expire between 2005 and 2010.

For the 2003 and 2002 tax years, our distributions declared before calendar year-end and distributed on or before January 31 of the following calendar year were less than 85% of REIT taxable income in those calendar years requiring us to incur a 4% excise tax provision on the shortfall. For the years ended December 31, 2003 and 2002, we provided for excise tax of $1.2 million and $1.0 million, respectively, which is reflected as a component of operating expenses on our Consolidated Statements of Income. As of December 31, 2003 and 2002, accrued excise tax payable was $1.2 million and $1.0 million, respectively, and is reflected as a component of accrued expenses and other liabilities on our Consolidated Balance Sheets.

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NOTE 9. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents the carrying values and estimated fair values of our financial instruments as of December 31, 2003 and 2002.

(in thousands)	December 31, 2003		December 31, 2002	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Real Estate Loans				
Residential: held-for-sale	$ —	$ —	$ 906	$ 906
Residential: held-for-investment	16,239,160	16,276,504	6,214,273	6,227,385
Commercial: held-for-sale	7,806	7,806	18,242	18,242
Commercial: held-for-investment	14,613	14,613	11,028	11,111
Real Estate Loan Securities				
Credit Enhancement Portfolio: available-for-sale	378,727	378,727	352,479	352,479
Securities Portfolio: available-for-sale	844,714	844,714	335,697	335,697
Interest Rate Agreements	(1,782)	(1,782)	(3,967)	(3,967)
Liabilities				
Short-Term Debt	236,437	236,437	99,714	99,714
Long-Term Debt	16,782,586	16,804,551	6,397,020	6,390,988

We estimate the fair value of certain assets and interest rate agreements using available market information and other appropriate valuation methodologies. Valuations of our residential real estate loans held-for-sale and held-for-investment are generally done on a pool basis while valuations of our commercial real estate loans held-for-sale and held-for-investment, securities available-for-sale, and securities issued through our Sequoia and Acacia programs that are classified as long-term debt are done on an individual basis. We believe the estimates we use 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, amount and timing of credit losses, supply and demand, liquidity, and other market factors.

In addition to our valuation processes, we are active acquirers and occasional sellers of the assets and interest rate agreements we own. Thus, we have the ability to understand and determine changes in assumptions that are taking place in the marketplace and make appropriate changes in our assumptions for valuing assets in our portfolio.

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

NOTE 10. STOCKHOLDERS' EQUITY

Class B 9.74% Cumulative Convertible Preferred Stock
On August 8, 1996, we issued 1,006,250 shares of Class B Preferred Stock. The preferred stock paid a dividend equal to the greater of (i) $0.755 per share, per quarter or (ii) an amount equal to the quarterly dividend declared per share on the common stock. The preferred stock ranked senior to our common stock as to the payment of dividends and liquidation rights. The liquidation preference entitled the holders of the preferred stock to receive $31.00 per share plus any accrued dividends before any distribution was made on the common stock.

Each share of the Preferred Stock was convertible at the option of the holder at any time into one share of common stock. As of December 31, 2002, 96,732 shares of the preferred stock had been converted into 96,732 shares of common stock. Effective October 1, 1999, we could redeem the preferred stock (i) for one share of common stock plus accumulated, accrued and unpaid dividends through the end of the prior dividend period, provided that for 20 trading days within a period of 30 consecutive trading days, the closing price of the common stock equaled or exceeded the Conversion Price of $31.00 per share or (ii) for cash at a redemption price of $31.00 per share, plus any accumulated, accrued and unpaid dividends through the date of redemption. On May 2, 2003, we redeemed all outstanding shares of preferred stock by converting those shares into shares of common stock.

Stock Option Plan

In March 2002, we adopted our Incentive Stock Plan (the Plan) for executive officers, employees, and non-employee directors that was approved by our shareholders in May 2002. The Plan authorizes our Board of Directors (or a committee appointed by our 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. ISOs and NQSOs awarded to employees have a maximum term of ten years and generally vest ratably over a four-year period. NQSOs awarded to non-employee directors have a maximum term of ten years and generally vest immediately or ratably over a three or four year period. Non-employee directors are automatically provided annual grants of NQSOs under the Plan. The Plan has been designed to permit our compensation committee to grant and certify awards that 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 our prior stock option plan. As of December 31, 2003 and 2002, 152,487 and 432,008 shares of common stock, respectively, were available for grant.

ISOs

Of the total shares of common stock available for grant, no more than 963,637 shares of common stock are cumulatively available for grant as ISOs. As of December 31, 2003 and 2002, 551,697 and 535,297 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.

Restricted Stock

As of December 31, 2003 and 2002, 10,003 and 15,750 shares, respectively, of restricted stock were outstanding. For the year ended December 31, 2003, we granted 1,253 shares of restricted stock to certain employees. We did not grant any shares of restricted stock for the year ended December 31, 2002. For the years ended December 31, 2003 and 2002, restrictions on 7,000 and 12,250 of these shares lapsed, respectively. Restrictions on the remaining shares of restricted stock lapse through January 1, 2006.

DERs

Redwood Trust has granted certain stock options that accrue and pay stock and cash DERs. This feature results in current expenses being incurred on stock and cash DERs that relate to stock option grants made prior to January 1, 2003. To the extent our REIT taxable income increases, our REIT dividend distribution requirement, and stock and cash DER expenses may increase. For the years ended December 31, 2003, 2002, and 2001, we accrued cash and stock DER expenses of $12.4 million, $7.2 million, and $3.4 million, respectively. Stock and cash DER expenses are included in operating expenses in our Consolidated Statements of Income.

Stock DERs represent shares of stock, which are issuable when the holders exercise the underlying stock options. All stock options with stock DERs issued before January 1, 2003 are considered variable stock awards under the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees.* In addition to the stock DER expense on these options, for the years ended December 31, 2003, 2002, and 2001, we recognized variable stock option expense of $5.7 million, $0.7 million, and $0.9 million, respectively. This expense is included in operating expenses in our Consolidated Statements of Income.

Stock DERs are accrued based on an estimate of our common stock dividend requirements. As of December 31, 2003 and 2002, there were 337,411 and 192,445 unexercised options with stock DERs under the Plan, respectively. Cash DERs are accrued based on an estimate of our common stock dividend requirements. As of December 31, 2003 and December 31, 2002, there were 1,546,042 and

1,529,051 unexercised options with cash DERs under the Plan, respectively. As of December 31, 2003 and December 31, 2002, there were 52,145 and 148,286 unexercised options with no DERs under the Plan, respectively.

A summary of the status of the Plan and changes during the years ended December 31, 2003, 2002, and 2001 is presented below.

	December 31, 2003		December 31, 2002		December 31, 2001	
(in thousands, except share data)	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding options at beginning of period	1,869,782	$ 22.58	1,618,501	$ 21.99	1,494,798	$ 21.95
Options granted	238,600	$ 50.29	262,850	$ 27.23	143,319	$ 23.92
Options exercised	(189,883)	$ 14.42	(20,749)	$ 16.93	(26,091)	$ 14.00
Options forfeited	(9,220)	$ 26.73	(5,861)	$ 31.31	(12,126)	$ 22.84
Dividend equivalent rights earned	26,319	—	15,041	—	18,601	—
Outstanding options at end of period	1,935,598	$ 26.48	1,869,782	$ 22.58	1,618,501	$ 21.99
Options exercisable at year-end	1,286,750	$ 22.89	1,214,167	$ 22.75	920,922	$ 24.09
Weighted average fair value of options granted during the year	$ 13.69		$ 7.06		$ 7.07	

The following table summarizes information about stock options outstanding at December 31, 2003.

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$0 to $10	63,555	4.3	$ 0.28	63,555	$ 0.28
$10 to $20	544,329	5.2	$ 13.69	450,141	$ 13.55
$20 to $30	710,242	6.5	$ 23.70	400,320	$ 21.55
$30 to $40	311,800	3.6	$ 37.31	276,762	$ 37.46
$40 to $50	95,972	3.7	$ 44.96	93,472	$ 45.03
$50 to $53	209,700	9.9	$ 52.46	2,500	$ 52.25
$0 to $53	1,935,598	5.8	$ 26.48	1,286,750	$ 22.89

Deferred Compensation Plan

In May 2002, our Board of Directors approved the Deferred Compensation Plan. The Deferred Compensation Plan allows eligible officers and directors to defer the payment of current salary and certain other forms of compensation and invest the deferrals with Redwood Trust. The plan allows for the investment of deferrals in either an interest crediting account or deferred stock units. For the years ended December 31, 2003 and 2002, $1.7 million and $0.5 million, respectively, was deferred in an interest crediting account under the Deferred Compensation Plan. Deferrals in the Deferred Compensation Plan are credited with accrued interest earned on participant accounts. The rate of accrual is set forth in the Deferred Compensation Plan and is based on a calculation of the marginal rate of return on our portfolio during the year. For the year ended December 31, 2003, $0.4 million of accrued interest was credited to the plan. For the year ended December 31, 2002, a negligible amount of accrued interest was credited to the plan. As of December 31, 2003, 25,417 deferred stock units had been granted through deferrals under the plan, which represented a value of $0.8 million at the time of grant. As of December 31, 2002, there were no deferrals invested in deferred stock units.

The following table provides detail on changes in participants' equity for the years ended December 31, 2003 and 2002.

(in thousands)	2003	2002
Transfer in of participants' payroll deductions from the 2002 Deferred Compensation Plan	$1,731	$492
Accrued interest earned on payroll deductions	393	18
Net change in participants' equity	2,124	510
Balance at beginning of period	510	—
Balance at end of period	$2,634	$510

The following table provides detail on the financial position of the Deferred Compensation Plan at December 31, 2003 and 2002.

(in thousands)	2003	2002
Net Assets Available for Participant Benefits		
Participants' payroll deductions receivable from Redwood Trust, Inc.	$2,223	$492
Accrued interest receivable on payroll deductions	411	18
Net Assets Available for Participant Benefits	2,634	510

Employee Stock Purchase Plan

In May 2002, our common shareholders approved the 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP). The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in Redwood Trust through the purchase of shares of common stock at a discount. A maximum of 100,000 shares of common stock may be purchased under the ESPP. Effective July 1, 2002, the ESPP allows eligible employees to have up to 15% of their annual gross compensation (including base salary, bonus, and cash DERs) withheld to purchase common stock at 85% of its market value. The maximum gross compensation any participant can contribute to the ESPP in any calendar quarter is $6,250. Market value under the ESPP is the lesser of the closing market price of the common stock as of the start of an offering period in the ESPP or the closing market price on the quarterly purchase date. For 2002, the offering period started on July 1st and consisted of two quarterly purchase periods. For 2003 and beyond, the offering period starts on January 1st of each calendar year and consists of four quarterly purchase periods. For the years ended December 31, 2003 and 2002, employees acquired an aggregate of 9,893 and 2,972 shares, respectively, of common stock at an average purchase price of $23.84 and $23.37 per share, respectively, under this Plan. As of both December 31, 2003 and 2002, there remained a negligible amount of uninvested employee contributions in the ESPP.

In the fourth quarter of 2003, we adopted, effective January 1, 2003, SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure — An Amendment of FASB Statement No. 123*. Through the adoption of this pronouncement, all shares purchased through the ESPP in 2003 are accounted for under the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation.* For the year ended December 31, 2003, we recorded an expense of $0.2 million for shares issued under the ESPP through these provisions. In 2002 we accounted for the ESPP under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations. Under these provisions we did not include any stock-based employee compensation cost in net income as awards granted under the ESPP were deemed non-compensatory.

(in thousands)	2003	2002
Transfer in of participants' payroll deductions from the 2002 Employee Stock Purchase Plan	$ 236	$ 70
Cost of common stock of Redwood Trust, Inc. issued to participants under the terms of the ESPP	(236)	(70)
Net change in participants' equity	—	—
Balance at beginning of period	—	—
Balance at end of period	—	—

Common Stock Repurchases
Our Board of Directors has approved the repurchase of a total of 7,455,000 shares of our common stock. A total of 6,455,000 shares were repurchased in 1998 and 1999. We did not repurchase any shares of common stock during the years ended December 31, 2003 and 2002. As of both December 31, 2003 and 2002, there remained 1,000,000 shares available under the authorization for repurchase. Repurchased shares have been returned to the authorized but unissued shares of Common Stock.

Common Stock Issuances
For the years ended December 31, 2003 and 2002, we issued 1,608,453 and 1,263,671 shares, respectively, of common stock through our Direct Stock Purchase and Dividend Reinvestment Plan for net proceeds of $61.2 million and $33.6 million, respectively. For the year ended December 31, 2003, we did not complete any secondary offerings. For the year ended December 31, 2002, we completed secondary offerings of 2,300,000 shares of common stock for net proceeds of $55.3 million.

Components of Accumulated Other Comprehensive Income
The components of accumulated other comprehensive income on our Consolidate Balance Sheet at December 31, 2003 include net unrealized gains of $79.3 million in our residential loan credit-enhancement portfolio, net unrealized gains of $3.3 million in our securities portfolio, and net realized losses on our interest rate agreements of $0.5 million, and net unrealized gains on our interest rate agreements of $0.1 million, for total accumulated comprehensive income of $82.2 million.

The components of accumulated other comprehensive income on our Consolidate Balance Sheet at December 31, 2002 include net unrealized gains of $76.7 million in our residential loan credit-enhancement portfolio, net unrealized losses of $4.5 million in our securities portfolio, and net unrealized losses on our interest rate agreements of $3.1 million, for total accumulated comprehensive income of $69.1 million.

NOTE 11. COMMITMENTS AND CONTINGENCIES

As of December 31, 2003, Redwood Trust was obligated under non-cancelable operating leases with expiration dates through 2013. The total future minimum lease payments under these non-cancelable leases are $8.1 million and are expected to be paid as follows: 2004 — $1.2 million; 2005 — $1.2 million; 2006 — $0.9 million; 2007 — $0.7 million; 2008 — $0.7 million; 2009 — $0.7 million; 2010 — $0.7 million; 2011 — $0.8 million; 2012 — $0.8 million; 2013 — $0.4 million. The majority of the future lease payments are related to the operating lease for our executive offices that we relocated to in the third quarter of 2003.

At December 31, 2003, there were no pending legal proceedings to which Redwood Trust was a party or of which any of its property was subject.

NOTE 12. SUBSEQUENT EVENTS

In January 2004, we issued $0.6 billion of long-term debt through Sequoia Mortgage Trust 2004-1, a trust established by Sequoia. This debt is collateralized by pools of adjustable-rate residential real estate loans.

The proceeds received from these issuances were used to acquire loans and pay down a portion of our short-term debt.

In January 2004, we sold residential credit-enhancement securities with a principal value of $23 million resulting in market value gains of $6 million on our Consolidated Statements of Income.

In January and February 2004, residential loan credit-enhancement securities with a principal value of $20 million were called pursuant to the original securitization documents. We recognized market value gains on these calls of $12 million through net unrealized and realized market value gains on our Consolidated Statements of Income.

In February 2004, we issued $0.7 billion of long-term debt through Sequoia Mortgage Trust 2004-2, a trust established by Sequoia. This debt is collateralized by pools of adjustable-rate residential real estate loans. We also issued $16 million of long-term debt through Sequoia Mortgage Funding 2004-A. This debt is collateralized by retained interests in previously issued adjustable-rate residential real estate loan securitizations through our Sequoia program. The proceeds received from these issuances were used to acquire loans and pay down a portion of our short-term debt.

During the first quarter through March 4, 2004, we have purchased or committed to purchase $2.6 billion of residential real estate loans, $80 million of other residential and commercial real estate loan securities, and $22 million of residential loan credit-enhancement securities.

In March 2004, our Board of Directors declared a regular cash dividend of $0.67 per share, as well as a special dividend of $0.50 per share for the first quarter of 2004. This regular cash dividend and the special dividend are payable on April 21, 2004 for shareholders of record on March 31, 2004.

In March 2004, our Board of Directors amended the Incentive Stock Plan for executive officer, employees, and non-employee directors, subject to shareholder approval in May 2004.

NOTE 13. QUARTERLY FINANCIAL DATA – UNAUDITED

Selected quarterly financial data follows:

(in thousands, except share data)	Three Months Ended			
	December 31	September 30	June 30	March 31
2003				
Operating results:				
Interest income	$ 108,262	$ 90,163	$ 71,426	$ 61,125
Interest expense	(68,594)	(55,532)	(41,802)	(36,933)
Net interest income	39,668	34,631	29,624	24,192
Net income available to common stockholders	70,035	24,648	22,137	14,893
Per share data:				
Net income – diluted	$ 3.53	$ 1.30	$ 1.20	$ 0.88
Dividends declared per common share	$ 0.65	$ 0.65	$ 0.65	$ 0.65
Special dividends declared per common share	$ 4.75	—	—	—
Dividends declared per preferred share	—	—	—	$ 0.755
2002				
Operating results:				
Interest income	$ 54,155	$ 42,093	$ 36,252	$ 30,716
Interest expense	(33,323)	(24,291)	(18,489)	(15,602)
Net interest income	20,832	17,802	17,763	15,114
Net income available to common stockholders	14,566	14,306	13,802	11,219
Per share data:				
Net income – diluted	$ 0.88	$ 0.88	$ 0.88	$ 0.80
Dividends declared per common share	$ 0.63	$ 0.63	$ 0.63	$ 0.62
Special dividends declared per common share	$ 0.125	$ 0.125	$ 0.125	—
Dividends declared per preferred share	$ 0.755	$ 0.755	$ 0.755	$ 0.755
2001				
Operating results:				
Interest income	$ 31,277	$ 33,172	$ 38,453	$ 41,637
Interest expense	(18,091)	(21,555)	(27,010)	(31,413)
Net interest income	13,186	11,617	11,443	10,224
Net income available to common stockholders	8,955	8,065	6,463	6,680
Per share data:				
Net income – diluted	$ 0.69	$ 0.75	$ 0.70	$ 0.74
Dividends declared per common share	$ 0.60	$ 0.57	$ 0.55	$ 0.50
Special dividends declared per common share	$ 0.15	$ 0.18	—	—
Dividends declared per preferred share	$ 0.755	$ 0.755	$ 0.755	$ 0.755

In the fourth quarter of 2003, we adopted, effective January 1, 2003, the fair value method of accounting for stock options expense and related items for all stock options granted since January 1, 2003 in accordance with the provisions of SFAS No. 123. The quarterly amounts above for “Net income available to common stockholders” and “Net income — diluted” reflect the impact of this adoption. The previously reported amounts for “Net income available to common stockholders” and “Net income — diluted” in the March 31, 2003, June 30, 2003 and September 30, 2003 Form 10-Q filings were (in thousands) $14,932, $22,212, and $24,636 and $0.88 per share, $1.21 per share, and $1.30 per share, respectively.

Report of Independent Auditors

To the Board of Directors and Stockholders of
Redwood Trust, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, comprehensive income, changes in stockholders' equity and cash flows present fairly, in all material respects, the financial position of Redwood Trust, Inc. and its subsidiaries at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the Notes to Consolidated Financial Statements, in 2001 the Company adopted the provisions of Emerging Issues Task Force ("EITF") 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* and in 2003 the Company adopted the provisions of FASB Interpretation No. 46, *Variable Interest Entities* and Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*.

/s/PricewaterhouseCoopers LLP

San Francisco, CA

March 4, 2004

EXHIBIT 10.15.1

2002 REDWOOD TRUST, INC. INCENTIVE STOCK PLAN

(LAST AMENDED MARCH 4, 2004)

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 Board approved amendments to the Plan on March 4, 2004 and directed that the amended Plan be submitted to stockholders of the Company for approval. 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) "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.

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

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

(4) "Committee" means the Compensation Committee of the Board, which shall be composed of not less than three Board members who shall be (i) Independent as defined by the rules of the New York Stock Exchange, as they may be amended from time to time; (ii) a Non-Employee Director as defined in Rule 16b-3 promulgated under Section 16 of the Securities Exchange Act of 1934, as amended; and (iii) an Outside Director as defined under Section 162(m) of the Internal Revenue Code of 1986, as amended, and rules promulgated thereunder.

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

(6) "DERs" shall mean dividend equivalent rights, which are the right to receive amounts on related Stock awards that are linked to dividends on the Stock and that may be paid currently in cash or Stock, or accrued in shares of deferred stock with or without compounding through subsequent payments or accruals on the accrued shares. Payment of such deferred stock from DER accruals on Stock Options and Stock Appreciation Rights may or may not be contingent upon the exercise of the related award, as determined by the Committee at the time of grant.

(7) "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 may determine.

(8) "Disability" means permanent and total disability as determined under the Company's disability program or policy.

(9) "Effective Date" shall mean the date provided pursuant to Section 11.

(10) "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.

(11) "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 4.

(12) "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, 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.

(13) "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.

(14) "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.

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

(16) "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.

(17) "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.

(18) "Participant" means any Eligible Employee, Non-Employee Director, or 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 under the Plan.

(19) "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.

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

(21) "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.

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

(23) "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.

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

(25) "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 Participants pursuant to the terms of the Plan: (a) Stock Options, (b) Stock Appreciation Rights, (c) Restricted Stock, (d) Deferred Stock, (e) Performance Shares or (f) any combination of the foregoing. DERs may be granted in conjunction with any of the Stock awards listed above.

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, Restricted Stock, Deferred Stock, Performance Shares or a combination of the foregoing, are to be granted to Participants 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, 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 the foregoing or anything else to the contrary in the Plan, any action or determination by the Administrator specifically affecting or relating to an award to a Non-Employee Director shall be approved and ratified by the Board.

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) shares of Stock accrued under DERs awarded to the Participant) would constitute more than 9.8% of the outstanding capital stock of the Company.

SECTION 3. STOCK SUBJECT TO PLAN.

(1) Subject to the following provisions of this Section 3, the maximum number of shares of Stock that may be issued with respect to awards granted under the Plan subsequent to the approval of Plan amendments on March 4, 2004 shall be equal to the sum of: (i) 735,000 shares of Stock; (ii) 148,540 shares of Stock remaining available for grant under the Plan immediately prior to the Board approval of the March 4, 2004 Plan amendments; (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 issued 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 issued for purposes of determining the maximum number of shares of Stock available for future awards under the Plan.

(4) Subject to Section 3(5), 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 materially amended or the shares subject to any such awards are surrendered).

(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) shall be 500,000 shares during any calendar year (regardless of whether such awards are canceled, forfeited, or materially amended 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 materially amended 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.

(5) 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 and 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, Non-Employee Directors, and consultants and agents of the Company or its Subsidiaries, shall be eligible to be granted Stock Options, DERs, Stock Appreciation Rights, Restricted Stock, Deferred Stock 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 those eligible.

SECTION 5. STOCK OPTIONS.

Stock Options may be granted alone or in addition to other awards granted under the Plan, including DERs. Any Stock Option granted under the Plan shall be in such form as the Administrator may from time to time approve, and the provisions of Stock Option awards need not be the same with respect to each optionee. Recipients of Stock Options shall enter into a Stock Option agreement with the Company, in such form as the Administrator shall determine, which agreement shall set forth, among other things, the exercise price, the term, and provisions regarding exercisability of the Stock 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 or 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.

(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) Limits on Transferability of Options.

(a) Subject to Section 5(5)(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(5)(b), and (z) subsequent transfers of transferred Stock Options shall be prohibited except those in accordance with Section 5(5)(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(6) 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(5)(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.

(6) Annual Limit on Incentive Stock Options. To the extent that the aggregate Fair Market Value (determined as of the date the Incentive Stock Option is granted) of shares of Stock with respect to which Incentive Stock Options granted to an optionee under this Plan and all other option plans of the Company, its Parent Corporation or any Subsidiary become exercisable

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

SECTION 6. STOCK APPRECIATION RIGHTS.

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

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

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

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

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

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

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

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

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

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

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

(h) Upon the exercise of a Free Standing Stock Appreciation Right, a recipient shall be entitled to receive up to, but not more than, an amount in cash or that number of shares of Stock (or any combination of cash or shares of Stock) equal in value to the excess of the Fair Market Value of one share of Stock as of the date of exercise over the price per share specified in the Free Standing Stock Appreciation Right (which price shall be no less than 100% of the Fair Market Value of the Stock on the date of grant) multiplied by the number of shares of Stock with respect to which the right is being exercised, with the Administrator having the right to determine the form of payment.

(i) Free Standing Stock Appreciation Rights shall be transferable or exercisable subject to the provisions governing the transferability and exercisability of Stock Options set forth in paragraphs (3) and (5) 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) 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 Participants 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 restrictions applicable to such Restricted Stock or Deferred Stock awards shall lapse during such Restricted Period; and all other conditions of the Restricted Stock, Deferred Stock, and Performance Share awards. The Administrator may also condition the grant of Restricted Stock, Deferred Stock, 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 grant). Except for certain limited situations, the Restricted Period for awards subject solely to continued employment restrictions shall be not less than three years from the date of grant. The Restricted Period for awards subject to meeting specified performance criteria shall generally not be shorter than twelve months or longer than five years.

(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.

SECTION 8. AMENDMENT AND TERMINATION.

The Board may amend, alter, suspend, terminate, or discontinue the Plan or any portion thereof at any time; provided, however, that no such amendment, alteration, suspension, discontinuation, or termination shall be made without (1) stockholder approval if such approval is necessary to qualify for or comply with any tax or regulatory requirement for which or with which the Board deems it necessary or desirable to qualify or comply or (2) the consent of the affected Participant, if such action would impair the rights of such Participant under any outstanding award. Notwithstanding anything to the contrary herein, the Committee may amend the Plan in such manner as may be necessary so as to have the Plan conform to local rules and regulations in any jurisdiction outside the United States.

The Administrator may amend the terms of any award theretofore granted prospectively or retroactively, but no such amendment shall (1) impair the rights of any Participant without his or her consent or (2) except for adjustments made pursuant to Section 3(5) or in connection with substitute awards, reduce the exercise price of outstanding Stock Options or Stock Appreciation Rights or cancel or amend outstanding Stock Options or Stock Appreciation Rights with an exercise price that is less than the exercise price of the original Stock Options or Stock Appreciation Rights without stockholder approval. Any change or adjustment to an outstanding Incentive Stock Option shall not, without the consent of the Participant, be made in a manner so

as to constitute a "modification" that would cause such Incentive Stock Option to fail to continue to qualify as an Incentive Stock Option. Notwithstanding the foregoing, any adjustments made pursuant to Section 3(5) shall not be subject to these restrictions.

SECTION 9. UNFUNDED STATUS OF PLAN.

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

SECTION 10. 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.

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.

EXHIBIT 10.30.2

BELVEDERE PLACE

Dated as of the ______ day of February, 2003

between

[_________],

as Landlord,

and

REDWOOD TRUST, INC.,

as Tenant

BELVEDERE PLACE

BASIC LEASE INFORMATION

1.	Date:	February ,2003
2.	Landlord:	
3.	Tenant:	Redwood Trust, Inc., a Maryland corporation
4.	Property:	The real property legally described on Exhibit A attached hereto
5.	Project:	The Property, together with the buildings known as One and Two Belvedere Place and all other improvements located thereon
6.	Building:	That certain office building located within the Belvedere Place office center located at One Belvedere Place, Mill Valley, California
7.	Premises:	[ ] rentable square feet located on the top floor of the Building, designated as Suite No. 300, as outlined on the floor plan attached hereto as Exhibit B
8.	Load Factor:	
9.	Initial Term:	One hundred twenty (120) months
10.	Delivery Date:	Upon full execution and delivery of this Lease by the parties
11.	Intentionally Omitted:	
12.	Commencement Date:	June 1, 2003
13.	Expiration Date:	May 31, 2013
14.	Initial Basic Rental Rate:	
15.	Fair Market Rental Value:	The average rental rate per rentable square foot per month (taking into account additional rent and all other monetary payments and considering any base year or expense stop applicable thereto), including all escalations, for all leases for comparable, unencumbered space for approximately the same lease term, executed at the Project and/or any other comparable Class A building in terms of size, quality, level of services, amenities, age and appearance

		located within the Southern Marin County area from the northern border of Corte Madera and Larkspur south to the Golden Gate Bridge, during the twelve (12) month period immediately preceding the date upon which the determination of Fair Market Rental Value is made, and having a commencement date within six (6) months of the date that the Fair Market Rental Value will commence under this Lease, and taking into account any tenant improvements and other concessions granted to Tenant and tenants under leases of such comparable space. The Fair Market Rental Value shall be determined in accordance with the terms and provisions of this Lease below.
16.	Security Deposit:	
17.	Base Year:	2003.
18.	Tenant's Proportionate Share:	The ratio which the rentable area of the Premises bears to the rentable area of the Project.
19.	Tenant Improvement Allowance:	
20.	Landlord's Broker:	
21.	Tenant's Broker:	
22.	Extension Term(s):	One (1) option term of sixty (60) months, in accordance with Section 40 below.

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BELVEDERE PLACE OFFICE LEASE

THIS LEASE is entered into by and between Landlord and Tenant, as specified in the Basic Lease Information, which is incorporated herein by reference, as of the date shown in Paragraph 1 of the Basic Lease Information.

1. PREMISES.

(a) *Initial Premises*. Landlord hereby leases to Tenant and Tenant hereby leases from Landlord the Premises (as defined in Paragraph 7 of the Basic Lease Information) upon and subject to the terms, covenants and conditions herein set forth. Tenant covenants, as a material part of the consideration for this Lease, to keep and perform each and all of said terms, covenants and conditions for which Tenant is responsible and that this Lease is entered into upon the condition of such performance.

(b) *Verification of Usable Square Feet of Premises, Building and Project*. For the purposes of this Lease, "usable square feet" for the Premises shall be calculated pursuant to the Standard Method for Measuring Floor Area in Office Buildings, [ANSI Z65.1 – 1996] ("**BOMA**"), and "rentable square feet" shall equal (i) the usable square feet contained within the Premises multiplied by (ii) the sum of (x) one (1) plus (y) the Load Factor (as defined in Paragraph 8 of the Basic Lease Information). The usable square feet and rentable square feet of the Premises, Building and the Project are subject to verification by Landlord's planner/designer promptly following the full execution and delivery of this Lease, and confirmation of the same by Tenant and Tenant's architect. In the event that Landlord's planner/designer determines that the amounts thereof are different from those set forth in this Lease, all amounts, percentages and figures appearing or referred to in this Lease based upon such incorrect amount (including, without limitation, the amount of rent and any security deposit) shall be modified in accordance with such determination. If such determination is made, it will be confirmed in writing by Landlord to Tenant.

2. TERM.

(a) *Initial Term*. Except as otherwise provided herein, the term of this Lease shall be the Initial Term as set forth in Paragraph 9 of the Basic Lease Information, commencing on the Commencement Date, and ending as of the Expiration Date, as set forth in Paragraph 12 and Paragraph 13, respectively, of the Basic Lease Information. The Initial Term, together with any extension term as to which a right has been properly exercised, shall be referred to as the "Term."

(b) *Confirmation of Lease Term*. When the Commencement Date has occurred, the parties shall promptly complete and execute a Notice of Lease Term Dates in the form of Exhibit C attached hereto.

3. BASIC RENT.

(a) *Basic Rent Payments*. Tenant agrees to pay Landlord each month, as base monthly rent, the Basic Rent as set forth in Paragraph 14 of the Basic Lease Information. Each monthly installment of Basic Rent shall be payable in advance on the first day of each calendar month during the Term, except that the first month's installment shall be paid upon the execution hereof. If the Term commences or ends on a day other than the first day of a calendar month, then the rent for the months in which this Lease commences or ends shall be prorated (and paid at the beginning of each such month) in the proportion that the number of days this Lease is in effect during such month bears to the total number of days in such month, and such partial month's installment shall be paid no later than the commencement of the subject month. In addition to the Basic Rent, Tenant agrees to pay as additional rent the amount of additional rent and rent adjustments and other charges required by this Lease. All rent shall be paid to Landlord, without prior demand and without any deduction or offset, in lawful money of the United States of America, at the address of Landlord designated in Section 31 below or to such other person or at such other place as Landlord may from time to time designate in writing. Except as otherwise provided in this Lease, in the event of a remeasurement or adjustment of the area of the Premises, the Basic Rent shall be recalculated using the Basic Rental Rate referenced in Paragraph 14 of the Basic Lease Information. Notwithstanding anything to the contrary contained in this Lease, Tenant's obligation for payment of Basic Rent shall be conditionally abated for each of the twelfth (12th), twenty-fourth (24th), thirty-sixth (36th), forty-eighth (48th), sixtieth (60th), seventy-second (72nd) and eighty-fourth (84th) months of the Term, provided that in the event of the termination of this Lease due to Tenant's default under this Lease (which is not cured within the applicable period for cure provided under this Lease), then the amount of monthly Basic Rent theretofore so conditionally abated shall be immediately due and payable in full to Landlord and Tenant shall not be entitled to any further conditional abatement of monthly Basic Rent hereunder, and provided that in the event of the expiration of the Term and Tenant's surrender of the Premises and performance of its other obligations under this Lease without such uncured default, then the abatement of monthly Basic Rent pursuant hereto shall be final and no longer conditional.

(b) *Intentionally omitted.*

(c) *Late Charge*. If Tenant fails to pay any installment of Basic Rent, additional rent or other charges within five (5) days after the same are due, then Tenant shall pay to Landlord a late charge equal to five percent (5%) of the amount so payable. Tenant acknowledges that late payments will cause Landlord to incur costs not contemplated by this Lease, the exact amount of which costs are extremely difficult and impracticable to calculate. The parties agree that the late charge described above represents a fair and reasonable estimate of the extra costs incurred by Landlord as a result of such late payment. Such late charge shall not be deemed a consent by Landlord to any late payment, nor a waiver of Landlord's right to insist upon timely payments at any time, nor a waiver of any remedies to which Landlord is entitled hereunder. In addition, all amounts payable by Tenant to Landlord hereunder, exclusive of the late charge described above, if not paid within five (5) days after such amounts are due, shall bear interest from the due date until paid at the rate (the "**Interest Rate**") of the greater of (i) two percent (2%) per annum plus the "Prime Rate" then most recently published in the Wall Street Journal (or a comparable replacement Prime Rate if the Wall Street Journal ceases to publish a Prime Rate) or (ii) ten percent (10%) per annum, provided that in no event shall the Interest Rate exceed the maximum rate of interest permitted to be collected by the Landlord by law.

4. ADDITIONAL RENT. In addition to the Basic Rent provided in Section 3 of this Lease, Tenant shall pay Tenant's Proportionate Share as specified in Paragraph 18 of the Basic Lease Information, of the increase (the "**Operating Expenses Increase**") in Actual Operating Expenses for each Operating Year over the Base Amount (as such terms are defined below). Tenant's Proportionate Share of the Building may change based on remeasurement or adjustment of the area of the Project or the Premises as described in Section 1(b). In addition, whenever additional space is added to the Premises Tenant's Proportionate Share of the Project shall increase accordingly.

(a) *Estimated Operating Expenses*. Within ninety (90) days after the close of each Operating Year during the Term, Landlord shall furnish Tenant a written statement of the "**Estimated Operating Expenses**" for the then current Operating Year, and a corresponding calculation of additional rent, which shall be one-twelfth (1/12) of Tenant's Proportionate Share of the amount, if any, by which the Estimated Operating Expenses exceed the Base Amount. Such additional amount shall be added to the monthly installment of Basic Rent payable by Tenant under this Lease for each month during such Operating Year.

(b) *Actual Operating Expenses*. Within ninety (90) days after the close of each Operating Year (except the Base Year) during the Term, Landlord shall deliver to Tenant a written statement setting forth the Actual Operating Expenses and actual Operating Expenses Increase during the preceding Operating Year. If such actual Operating Expenses Increase for any Operating Year exceed the estimated amount theretofore paid by Tenant to Landlord on account thereof pursuant to Section 4(a), Tenant shall pay the amount of such excess to Landlord as additional rent within thirty (30) days after receipt by Tenant of such statement. If such statement shows the actual Operating Expenses Increase to be less than the estimated amount theretofore paid by Tenant to Landlord on account thereof pursuant to Section 4(a), then the amount of such overpayment by Tenant shall be paid by Landlord to Tenant within thirty (30) days following the date of such statement or, at Landlord's option, credited by Landlord to the payment of rent next due.

(c) *Determinations*. The determination of Actual Operating Expenses and Estimated Operating Expenses shall be made by Landlord. Any payments pursuant to this Section 4 shall be additional rent payable by Tenant hereunder, and in the event of nonpayment thereof, Landlord shall have the same rights with respect to such nonpayment as it has with respect to any other nonpayment of rent hereunder.

(d) *End of Term*. If this Lease shall terminate on a day other than the last day of an Operating Year, the amount of any adjustment between Estimated Operating Expenses and Actual Operating Expenses with respect to the Operating Year in which such termination occurs shall be prorated on the basis which the number of days from the commencement of such Operating Year, to and including such termination date, bears to three hundred sixty-five (365); and any amount payable by Landlord to Tenant or Tenant to Landlord with respect to such adjustment shall be payable within thirty (30) days after delivery of the statement of Actual Operating Expenses with respect to such Operating Year.

(e) *Definitions*. The following terms shall have the respective meanings hereinafter specified:

(1) “**Base Amount**” shall mean an amount equal to the Actual Operating Expenses for the Base Year (as defined in Paragraph 17 of the Basic Lease Information); provided that, if the Project is not open and operating during the entire Base Year, then the Actual Operating Expenses actually incurred for the Base Year (adjusted, if less than ninety-five percent (95%) of the total rentable area of the Project had been occupied for the entire Base Year, as if ninety-five percent (95%) of the total rentable area of the Project had been occupied for the entire Base Year) shall be annualized to reflect the Actual Operating Expenses that would have been incurred had the Project been operating during the entire Base Year.

(2) “**Operating Year**” shall mean a calendar year commencing January 1 and ending December 31.

(3) “**Operating Expenses**” shall mean all expenses paid or incurred by Landlord for maintaining, owning, operating and repairing the Project (as defined in Paragraph 5 of the Basic Lease Information), including, without limitation, the Building, and the personal property used in conjunction therewith, including, but not limited to expenses incurred or paid for: (i) Property Taxes (as hereinafter defined); (ii) utilities for the Project, including but not limited to electricity, power, gas, steam, oil or other fuel, water, sewer, lighting, heating, air conditioning and ventilating; (iii) permits, licenses and certificates necessary to operate, manage and lease the Project; (iv) insurance Landlord deems appropriate to carry consistent with insurance customarily maintained by owners of similar Class A office buildings in the vicinity of the Project, or is required to carry by any mortgagee under any mortgage encumbering the Project or any portion thereof or interest therein or encumbering any of Landlord’s or the property manager’s personal property used in the operation of the Project; (v) supplies, tools, equipment and materials used in the operation, repair and maintenance of the Project; (vi) accounting, legal, inspection, consulting, concierge and other services; (vii) equipment rental (or installment equipment purchase or equipment financing agreements); (viii) management agreements (including the cost of any management fee actually paid thereunder and the fair rental value of any office space provided thereunder, up to customary and reasonable amounts); (ix) wages, salaries and other compensation and benefits (including the fair value of any parking privileges provided) for all persons engaged in the operation, maintenance or security of the Project, and employer’s Social Security taxes, unemployment taxes or insurance, and any other taxes which may be levied on such wages, salaries, compensation and benefits; (x) payments under any easement, operating agreement, declaration, restrictive covenant, or instrument pertaining to the sharing of costs in any planned development or similar arrangement; (xi) operation, repair, and maintenance of all systems and equipment and components thereof (including replacement of components, with any capital expenditure amortized as provided below); (xii) janitorial service, alarm and security service, window cleaning, trash removal, elevator maintenance, and cleaning of walks, parking facilities and building walls; (xiii) replacement of wall and floor coverings, ceiling tiles and fixtures in lobbies, corridors, restrooms and other common or public areas or facilities (except that replacements of such items in connection with an overall remodeling of the lobbies and/or other common areas shall be treated as a capital expenditure and amortized as provided below; (xiv) maintenance and replacement of shrubs, trees, grass, sod and other landscape items,

irrigation systems, drainage facilities, fences, curbs, and walkways; (xv) re-paving and re-striping parking facilities; (xvi) and roof repairs and replacement (provided that any such replacement shall be amortized as provided below), and (xvii) capital expenditures made primarily to reduce Operating Expenses, or to comply with any laws or other governmental requirements, or for replacements (as opposed to additions or new improvements) of non-structural items located in the common areas of the Project required to keep such areas in good condition, which capital expenditures shall be amortized for purposes of this Lease over their reasonably anticipated useful lives. Notwithstanding the foregoing, Operating Expenses shall not include (a) depreciation, interest and amortization on mortgages or other debt costs or ground lease payments, if any; (b) legal fees in connection with leasing, tenant disputes or enforcement of leases; (c) real estate brokers' leasing commissions; (d) improvements or alterations to tenant spaces; (e) the cost of providing any service directly to and paid directly by, any tenant; (f) costs of any items to the extent Landlord receives reimbursement from insurance proceeds or from a third party (such proceeds to be deducted from Operating Expenses in the year in which received); and (g) capital expenditures except those capital expenditures made primarily to reduce Operating Expenses, or to comply with any laws or other governmental requirements, or for replacements (as opposed to additions or new improvements) of non-structural items located in the common areas of the Project required to keep such areas in good condition, which capital expenditures (together with reasonable financing charges) shall be amortized for purposes of this Lease over their reasonably anticipated useful lives.

(4) "**Estimated Operating Expenses**" shall mean Landlord's estimate of Operating Expenses for the following Operating Year, adjusted as if ninety-five percent (95%) of the total rentable area of the Property will be occupied for the entire Operating Year.

(5) "**Actual Operating Expenses**" shall mean the actual Operating Expenses for any Operating Year, adjusted, if less than ninety-five percent (95%) of the total rentable area of the Project had been occupied for the entire Operating Year, as if ninety-five percent (95%) of the total rentable area of the Project had been occupied for the entire Operating Year.

(6) "**Property Taxes**" shall mean all real and personal property taxes and assessments imposed by any governmental authority or agency on the Project; any assessments levied in lieu of such taxes; any non-progressive tax on or measured by gross rents received from the rental of space in the Project; and any other costs levied or assessed by, or at the direction of, any federal, state, or local government authority in connection with the use or occupancy of the Project or the Premises or the parking facilities serving the Project; any tax on this transaction or any document to which Tenant is a party creating or transferring an interest in the Premises, and any expenses, including the reasonable cost of attorneys or experts, incurred by Landlord in seeking reduction by the taxing authority of the above-referenced taxes, less any tax refunds obtained as a result of an application for review thereof; but shall not include any net income, franchise, estate or inheritance taxes.

5. SECURITY DEPOSIT. Tenant has deposited with Landlord the Security Deposit specified in Paragraph 16 of the Basic Lease Information. Said sum shall be held by Landlord as security for the faithful performance by Tenant of all of Tenant's obligations under this Lease. If Tenant defaults with respect to any provision hereof, including but not limited to the provisions relating to the payment of rent, Landlord may (but shall not be required to) use, apply or retain all or part of the Security Deposit for the payment of any rent or any other sum in default, or for the payment of any other amount which Landlord may incur by reason of Tenant's default or to compensate Landlord for any other loss or damage which Landlord may suffer by reason of Tenant's default. If any portion of the deposit is so used or applied, Tenant shall, upon demand, immediately deposit cash with Landlord in an amount sufficient to restore the Security Deposit to its original amount. Tenant's failure to do so shall be a material breach of this Lease. Landlord shall not be required to keep the Security Deposit separate from its general funds, and Tenant shall not be entitled to interest on such deposit. If Tenant shall fully and faithfully perform all of its obligations under this Lease, the Security Deposit or any balance thereof shall be returned to Tenant (or, at Landlord's option, to the last assignee of Tenant's interests hereunder) after the expiration of the Term, provided that Landlord may retain all or a portion of the Security Deposit in an amount reasonably determined by Landlord to be necessary to cover any amounts owed by Tenant for the clean-up and repair of the Premises if Tenant has failed to satisfy its obligations under Section 7(b) of this Lease, and Actual Operating Expenses during the Term.

6. USES; HAZARDOUS MATERIAL.

(a) *Use*. Tenant agrees that it will use the Premises for general office purposes, and for no other business or purpose. Tenant, at its sole cost and expense, shall promptly comply with all local, state and federal laws, statutes, ordinances and governmental rules, regulations or requirements now in force or which may hereinafter be in force, including, without limitation, the Americans with Disabilities Act, 42 U.S.C. § 12101 et seq. and any governmental regulations relating thereto, including any required alterations for purposes of "public accommodations" under such statute which arise as a result of the particular nature of the use of the Premises by Tenant or any of the Tenant Parties. Tenant shall not use or permit the Premises to be used in any manner nor do any act which would increase the existing rate of insurance on the Project or cause the cancellation of any insurance policy covering the Project, nor shall Tenant permit to be kept, used or sold, in or about the Premises, any article which may be prohibited by the standard form of fire insurance policy, unless Tenant obtains an endorsement to the policy allowing such activity. Tenant shall not during the Term (i) commit or allow to be committed any waste upon the Premises, or any public or private nuisance in or around the Project, (ii) allow any sale by auction upon the Premises, (iii) place any loads upon the floor, walls, or ceiling of the Premises which endanger the Building, (iv) use any apparatus, machinery or device in or about the Premises which will cause any substantial noise or vibration or in any manner damage the Building, (v) place any harmful liquids in the drainage system or in the soils surrounding the Project, or (vi) disturb or unreasonably interfere with other tenants of the Project. If any of Tenant's office machines or equipment disturbs the quiet enjoyment of any other tenant in the Building, then Tenant shall provide adequate insulation, or take such other action as may be necessary to eliminate the disturbance, all at Tenant's sole cost and expense.

(b) *Hazardous Material.* As used herein, the term "**Hazardous Material**" means any hazardous or toxic substance, material or waste which is or becomes regulated by, or is dealt with in, any local governmental authority, the State of California or the United States Government. Accordingly, the term "**Hazardous Material**" includes, without limitation, any material or substance which is (i) defined as a "hazardous waste," "extremely hazardous waste" or "restricted hazardous waste" under Sections 25115, 25117 or 25122.7, or listed pursuant to Section 25140 of the California Health and Safety Code, Division 20, Chapter 6.5 (Hazardous Waste Control Law), (ii) defined as a "hazardous substance" under Section 25316 of the California Health and Safety Code, Division 20, Chapter 6.95 (Hazardous Materials Release Response Plans and Inventory), (iii) defined as a "hazardous substance" under Section 25281 of the California Health and Safety Code, Division 20, Chapter 6.7 (Underground Storage of Hazardous Substances), (iv) petroleum, (v) asbestos, (vi) listed under Article 9 or defined as hazardous or extremely hazardous pursuant to Article 11 of Title 22 of the California Administrative Code, Division 4, Chapter 20, (vii) designated as a "hazardous substance" pursuant to Section 311 of the Federal Water Pollution Control Act (33 U.S.C. § 1317), (viii) defined as a "hazardous waste" pursuant to Section 1004 of the Federal Resource Conservation and Recovery Act, 42 U.S.C. § 6902 et seq., or (ix) defined as a "hazardous substance" pursuant to Section 101 of the Compensation and Liability Act, 42 U.S.C. § 9601 et seq. Tenant shall not (either with or without negligence) cause or permit the escape, disposal or release of any Hazardous Materials in the Premises or the Project by any Tenant Parties. Tenant shall not allow the storage or use of Hazardous Materials in the Premises in any manner not sanctioned by law or by the highest standards prevailing in the industry for the storage or use of such substances or materials, nor allow to be brought onto the Building or Project any such materials or substances, except that Tenant may maintain products in the Premises which are incidental to the operation of its offices, such as photocopy supplies, secretarial supplies and limited janitorial supplies which products contain chemicals which are categorized as Hazardous Materials, provided that the use of such products in the Premises by Tenant shall be in compliance with applicable laws and shall be in the manner in which such products are designed to be used. In addition, Tenant shall execute affidavits, representations and the like from time to time at Landlord's request concerning Tenant's best knowledge and belief regarding the presence of Hazardous Materials on the Premises. The covenants of this Section 6(b) shall survive the expiration or earlier termination of the Lease.

(c) *Environmental Obligations.* Landlord and Tenant shall notify each other in writing of (i) any enforcement, clean-up, removal or other governmental action instituted with regard to Hazardous Materials involving the Project, (ii) any claim made by any person against either of the parties related to Hazardous Materials in the Premises or the Project, (iii) any reports made to any governmental agency arising out of or in connection with Hazardous Materials in the Premises or the Project including, without limitation, any written complaints, notices or warnings, and (iv) any spill, release, discharge or disposal of Hazardous Materials in the Premises or the Project that is required to be reported to any governmental agency or authority under any applicable governmental law, rule or regulation. Tenant shall indemnify and hold Landlord and its affiliates harmless with respect to any environmental claims or liabilities which occur as a result of the breach by Tenant of any of Tenant's covenants set forth in Section 6(b) above or this Section 6(c) and from any escape, seepage, leakage, spillage, discharge, emission, release from, onto or into the Premises, the Building or the Project of any Hazardous

Materials to the extent caused by Tenant or Tenant's agents, contractors, trustees, partners, members, shareholders, officers, employees or invitees (collectively, "**Tenant Parties**").

7. MAINTENANCE AND REPAIRS.

(a) *Landlord's Obligations*. Landlord shall maintain and keep in good repair the foundations, exterior walls, structural portions of the roof and other structural portions of the Building, the common areas of the Building and the Project, and the electrical, plumbing, heating and ventilating equipment in the Building, except such portions thereof as may be specially installed for Tenant or otherwise altered by Tenant in connection with Tenant's work or otherwise; and except that all damage or injury to the Premises, the Building or the equipment and improvements therein caused by any act, neglect, misuse or omission of any duty by Tenant or by any Tenant Parties shall be paid by Tenant to the extent that the repair of any such damage or injury is not covered by Landlord's insurance. Landlord shall not be liable for any failure to make any such repairs or to perform any maintenance unless such failure shall persist for an unreasonable time after written notice of the need of such repairs or maintenance is given by Tenant to Landlord. Tenant hereby waives and releases its right to make repairs at Landlord's expense under Sections 1941 and 1942 of the California Civil Code or under any similar law, statute or ordinance now or hereafter in effect. Landlord makes no warranty as to the quality, continuity or availability of the telecommunications services in the Building, and Tenant hereby waives any claim against Landlord for any actual or consequential damages (including damages for loss of business) if Tenant's telecommunications services in any way are interrupted, damaged or rendered less effective, except to the extent caused by the gross negligence or willful misconduct of Landlord, its agents or employees.

(b) *Tenant's Obligations*. Tenant shall at its expense maintain, repair and replace all portions of the Premises and the equipment or fixtures relating thereto, except to the extent specified in Section 7(a), above, at all times in good condition and repair, all in accordance with the laws of the State of California and all health, fire, police and other ordinances, regulations and directives of governmental agencies having jurisdiction over such matters. Tenant shall replace at Tenant's sole expense any glass that may be broken in the Premises, and elsewhere in the Building or the Project if done through any fault or negligence of any of the Tenant Parties, with glass of the same size, specifications and quality, with signs thereon, if required. At the expiration of the Term, Tenant shall surrender the Premises in the same condition as it was received, normal wear and tear and damage by fire or other casualty excepted, and will clean all walls, floors, suspended ceilings and carpeting therein. Tenant shall indemnify Landlord for any loss or liability resulting from any delay by Tenant in surrendering the Premises to Landlord as provided herein.

8. ALTERATIONS.

(a) *Landlord's Consent*. Tenant shall not make any alterations, additions or improvements (collectively, "**Alterations**") in or to the Premises or make changes to locks on doors or add, disturb or in any way change any plumbing or wiring without obtaining the prior written consent of Landlord, which consent shall not be unreasonably withheld provided that the Alterations do not affect the Building's structure, safety, systems or aesthetics or cause the release of Hazardous Substances; except, however, that Tenant may make non-structural, interior

Alterations to the Premises costing less than $10,000.00 per work of Alterations and not affecting the Building mechanical or utility systems, without the prior written consent of Landlord but upon not less than ten (10) days prior written notice to Landlord.

(b) *Performance of Work*. All Alterations shall be made at Tenant's sole expense and by contractors or mechanics approved by Landlord, shall be made at such times and in such manner as Landlord may from time to time reasonably designate, and shall become the property of Landlord without its obligation to pay therefor at the expiration or earlier termination of this Lease. All work with respect to any Alterations shall be performed in a good and workmanlike manner, shall be of a quality equal to or exceeding the then existing construction standards for the Project and must be of a type, and the floors and ceilings must be finished in a manner, customary for general office use and other uses common to first-class (Class A) office buildings in the vicinity. Alterations shall be diligently prosecuted to completion to the end that the Premises shall be at all times a complete unit except during the period necessarily required for such work. All Alterations shall be made strictly in accordance with all laws, regulations and ordinances relating thereto, and no interior improvements installed in the Premises may be removed unless the same are promptly replaced with interior improvements of the same or better quality. Landlord hereby reserves the right to require any contractor or mechanic working in the Premises to provide lien waivers and liability insurance covering the Alterations to the Premises and, as to any proposed Alterations costing in excess of $100,000.00, to require Tenant to secure, at Tenant's sole cost and expense, completion and lien indemnity bonds satisfactory to Landlord, and/or to require such other instruments as may be reasonably requested by Landlord. In addition to the foregoing, Tenant shall provide Landlord with evidence that Tenant or Tenant's general contractor carries "Builder's All Risk" insurance in an amount approved by the Landlord covering the construction of such Alterations, and such other insurance as the Landlord may require, it being understood and agreed that all of such Alterations shall be insured by Tenant pursuant to Section 14(a) of this Lease immediately upon completion thereof. Tenant shall give Landlord ten (10) days written notice prior to the commencement of any Alterations and shall allow Landlord to enter the Premises and post appropriate notices to avoid liability to contractors or material suppliers for payment for any Alterations. All Alterations shall remain in and be surrendered with the Premises as a part thereof at the expiration or earlier termination of this Lease, without disturbance, molestation or injury, provided that Landlord may require any Alterations to be removed upon the expiration or earlier termination of this Lease, provided that Landlord shall not be permitted to require removal of any Alterations which, at the time of Landlord's approval of such Alterations, Landlord agreed would not be subject to such requirement for removal (and Landlord hereby agrees to notify Tenant promptly following request therefor from Tenant, whether any such proposed Alterations shall be subject to such requirement for removal). Further, Tenant shall not be required to remove any of the initial Tenant Improvements constructed in the Premises pursuant to Exhibit F. In such event, all expenses to restore said space to normal building standards shall be borne by Tenant. If Tenant fails to complete the removal and/or to repair any damage caused by the removal of any Alterations which are required to be removed as provided above, Landlord may do so and may charge the cost thereof to Tenant.

(c) *Landlord's Expenses; Administrative Fee*. Tenant shall pay to Landlord, as additional rent, any out-of-pocket costs incurred by Landlord in connection with the review, approval and supervision of the Alterations and for any additional Building services provided to

Tenant or to the Premises in connection with any such Alterations which are beyond the normal services provided to occupants of the Building. Under no circumstances shall Landlord be liable to Tenant for any damage, loss, cost or expense incurred by Tenant on account of Tenant's plans and specifications, Tenant's contractors or subcontractors, or Tenant's design of any work, construction of any work or delay in completion of any work.

9. TENANT'S PROPERTY.

(a) *Removal Upon Expiration of Lease*. All articles of personal property and all business and trade fixtures, machinery and equipment, furniture and movable partitions owned by Tenant or installed by Tenant at its expense in the Premises shall be and remain the property of Tenant and may be removed by Tenant at any time during the Term, subject to the other requirements of this Lease. If Tenant shall fail to remove all of such property from the Premises at the expiration of the Term or within ten (10) days after any earlier termination of this Lease for any cause whatsoever, Landlord may, at its option, remove the same in any manner that Landlord shall choose, and store such property without liability to Tenant for loss thereof. In such event, Tenant agrees to pay Landlord upon demand any and all expenses incurred in such removal, including court costs and attorneys' fees and storage charges on such property for any length of time that the same shall be in Landlord's possession. Landlord may, at its option, upon written notice to Tenant, sell said property or any of the same, at private sale and without legal process, for such price as Landlord may obtain and apply the proceeds of such sale to any amounts due under this Lease from Tenant to Landlord and to the expense incident to the removal and sale of said property.

(b) *Personal Property Taxes*. Tenant shall be liable for and shall pay, at least ten (10) days before delinquency, all taxes levied against any personal property or trade fixtures placed by Tenant in or about the Premises. If any such taxes on Tenant's personal property or trade fixtures are levied against Landlord or Landlord's property or if the assessed value of the Premises or Landlord's obligations are increased by a value placed upon such personal property or trade fixtures of Tenant and if Landlord, after written notice to Tenant, pays the taxes or obligations based upon Tenant's personal property or trade fixtures, which Landlord shall have the right to do regardless of the validity thereof, but only under proper protest if requested by Tenant, Tenant shall, upon demand and receipt by Tenant of appropriate documentation confirming that the taxes were levied against Tenant's personal property or trade fixtures, repay to Landlord the taxes or obligations so levied against Landlord, or the portion of such taxes or obligations resulting from such increase in the assessment.

10. ENTRY BY LANDLORD. After reasonable notice (except in emergencies, where no such notice shall be required), Landlord, its authorized agents, contractors, and representatives shall at any and all times have the right to enter the Premises to inspect the same, to supply janitorial service and any other service to be provided by Landlord to Tenant hereunder, to show the Premises to prospective purchasers or tenants, to post notices, to alter, improve or repair the Premises or any other portion of the Building, all without being deemed guilty of any eviction of Tenant and without abatement of rent. Landlord may, in order to carry out such purposes, erect scaffolding and other necessary structures where reasonably required by the character of the work to be performed, provided that the business of Tenant shall be interfered with as little as is reasonably practicable. Landlord shall at all times have and retain a key with which to unlock all doors in the Premises, excluding Tenant's vaults and safes. Landlord shall have the right to use any and all means which Landlord may deem proper to open said doors in an emergency in order to obtain entry to the Premises. Any entry to the Premises obtained by Landlord pursuant to the terms hereof shall not be deemed to be a forcible or unlawful entry into the Premises, or an eviction of Tenant from the Premises or any portion thereof, and Tenant hereby waives any claim for damages for any injury or inconvenience to or interference with Tenant's business, any loss of occupancy or quiet enjoyment of the Premises, and any other loss in, upon and about the Premises, except to the extent any such damage or loss is caused by the gross negligence or wilful misconduct of Landlord or any of Landlord's employees, agents or contractors and is not covered by the insurance maintained by Tenant (and would not have been covered by Tenant's insurance had Tenant maintained the insurance required to be maintained by Tenant pursuant to this Lease).

11. LIENS AND INSOLVENCY. Tenant shall keep the Premises, the Building and the Project free from any liens or encumbrances of any kind or nature arising out of any work performed, materials ordered or obligations incurred by or on behalf of Tenant. If Tenant becomes insolvent, makes an assignment for the benefit of creditors, or if legal proceedings are instituted seeking to have Tenant adjudicated bankrupt, reorganized or rearranged under the bankruptcy laws of the United States, or if this Lease shall, by operation of law or otherwise, pass to any person or persons or entity other than Tenant, Landlord may, at its option, terminate this Lease, which termination shall reserve unto Landlord all of the rights and remedies available under Sections 27 and 29 hereof, and Landlord may accept rent from such trustee, assignee or receiver without waiving or forfeiting said right of termination.

12. INDEMNIFICATION. Tenant shall indemnify, defend and hold Landlord, its members, employees and agents (collectively, the '**Landlord Parties**") harmless from and against all claims, losses, liabilities, damages, costs, expenses and claims arising from or relating to (a) Tenant's use of the Premises or the conduct of its business or any activity, work, or thing done, permitted or suffered by Tenant in or about the Premises, (b) any breach or default in the performance of any obligation to be performed by Tenant under the terms of this Lease, (c) any act, neglect, fault or omission of any of the Tenant Parties, and (d) all costs, attorneys' fees, expenses and liabilities incurred in or about such claims or any action or proceeding brought thereon, except to the extent any such damage or loss is caused by the negligence or wilful misconduct of Landlord or any of Landlord's employees, agents or contractors and is not covered by the insurance maintained by Tenant (and would not have been covered by Tenant's insurance had Tenant maintained the insurance required to be maintained by Tenant pursuant to this Lease). In case any action or proceeding shall be brought against any of the Landlord Parties by reason of any such claim, Tenant upon written notice from Landlord shall defend the same at Tenant's expense by counsel approved in writing by Landlord. Tenant, as a material part of the consideration to Landlord, hereby assumes all risk of and waives all claims against the Landlord Parties with respect to damage to property or injury to persons in, upon or about the Premises from any cause whatsoever except that which is caused by the negligence or wilful misconduct of Landlord or any of Landlord's employees, agents or contractors and is not covered by the insurance maintained by Tenant (and would not have been covered by Tenant's insurance had Tenant maintained the insurance required to be maintained by Tenant pursuant to this Lease).

13. DAMAGE TO TENANT'S PROPERTY. Notwithstanding anything to the contrary in this Lease, the Landlord Parties shall not be liable for (a) any damage to any property entrusted to employees of the Project or its property managers, (b) loss or damage to any property by theft or otherwise, (c) any injury or damage to property resulting from fire, explosion, falling plaster, steam, gas, electricity, water or rain which may leak from any part of the Building or from the pipes, appliances or plumbing work therein or from the roof, street or sub-surface or from any other place or resulting from dampness or any other cause whatsoever, or (d) any damage or loss to the business or occupation of Tenant arising from the acts or neglect of other tenants or occupants of, or invitees to, the Project. Tenant shall give prompt written notice to Landlord in case of fire or accident in the Premises or in the Building or of defects therein or in the fixtures or equipment.

14. INSURANCE. Tenant shall, during the entire Term of this Lease and any other period of occupancy, at its sole cost and expense, keep in full force and effect the following insurance:

(a) *All-Risk Property Insurance*. Standard form property insurance insuring against the perils of fire, vandalism, malicious mischief, cause of loss-special form ("**All-Risk**"), sprinkler leakage, and earthquake sprinkler leakage (provided that Tenant may self-insure for such earthquake sprinkler leakage coverage). This insurance policy shall be upon all trade fixtures and other property owned by Tenant, for which Tenant is legally liable and/or that was installed by or on behalf of Tenant, and which is located in the Building, including, without limitation, Alterations, furniture, fittings, installations, fixtures, tenant improvements and any other personal property, in an amount not less than the full replacement cost thereof. If there shall be a dispute as to the amount which comprises full replacement cost, the decision of Landlord or any mortgagees of Landlord shall be conclusive. Such policy shall name Landlord and any mortgagees of Landlord as additional insured parties, as their respective interests may appear.

(b) *Liability Insurance*. Commercial General Liability Insurance insuring Tenant against any liability arising out of the lease, use, occupancy, or maintenance of the Premises and all areas appurtenant thereto. Such insurance shall be in the amount of Two Million Dollars ($2,000,000) Combined Single Limit for injury to or death of one or more persons in an occurrence and Three Million Dollars ($3,000,000) aggregate, and for damage to tangible property (including loss of use) in an occurrence, with an Additional Insured — Landlord Endorsement. The policy shall insure the hazards of premises and operations, independent contractors, contractual liability (covering the indemnity contained in Section 12 hereof) and shall (i) name Landlord as an additional insured, (ii) contain a cross-liability provision, (iii) contain a provision that "the insurance provided the landlord hereunder shall be primary and noncontributing with any other insurance available to the landlord," and (iv) include fire legal liability coverage in the amount of One Million Dollars ($1,000,000)

(c) *Workers' Compensation Insurance*. Workers' Compensation and Employer's Liability Insurance (as required by state law).

(d) *Boiler and Machinery Insurance*. If Tenant installs any boiler, pressure object, machinery, fire suppression system, supplemental air conditioning or other mechanical equipment within the Premises, Tenant shall also obtain and maintain at Tenant's expense, boiler and machinery insurance covering loss arising from the use of such equipment.

(e) *Other Insurance*. Any other form or forms of insurance as Tenant or Landlord or any mortgagees of Landlord may reasonably require from time to time in form, amounts and for insurance risks against which a prudent tenant would protect itself consistent with insurance customarily required by owners of Class A office buildings in the vicinity of the Premises.

All such policies shall be written in a form reasonably satisfactory to Landlord and shall be taken out with insurance companies qualified to issue insurance in the State of California and holding an A.M. Best's Rating of "A" and a Financial Size Rating of "X" or better, as set forth in the most current issue of Best's Key Rating Guide. Such insurance shall provide that it is primary insurance, and not contributory with any other insurance in force for or on behalf of Landlord. Prior to the commencement of the Term, Tenant shall deliver to Landlord certificates of insurance evidencing the existence of the amounts and forms of coverage required above and, except for the All-Risk insurance, naming Landlord, the holder of any Prior Lien and the property manager each as an additional insured. No such policy shall be cancelable, terminable or reducible in coverage except after thirty (30) days prior written notice to Landlord. Tenant shall, within ten (10) days prior to the expiration of such policies, furnish Landlord with renewals or "binders" thereof, or Landlord may order such insurance and charge the cost thereof to Tenant as additional rent, if Tenant fails to so notify Landlord. If Landlord obtains any insurance that is the responsibility of Tenant under this Section 14, Landlord shall deliver to Tenant a written statement setting forth the cost of any such insurance and showing in reasonable detail the manner in which it has been computed.

Landlord shall, during the entire term of this Lease, as an item of Operating Expenses, keep in full force and effect the following insurance: (A) All Risk insurance (including a vandalism and malicious mischief endorsement and sprinkler leakage coverage, and also covering such other risks as Landlord or Landlord's lender may require) upon the Project (including the Tenant Improvements constructed under Section 30 below, but excluding any property which Tenant is obligated to insure under Section 14(a) above) in an amount not less than the full replacement cost thereof (excluding footings, foundations and excavation), and including commercially reasonable rental loss coverage for losses covered by such insurance policy, which insurance policy or policies shall name Landlord as a named insured, and the deductible under which All Risk policy shall not exceed such commercially reasonable amount as Landlord determines to be appropriate given prudent risk management practices; and (B) commercial general liability insurance coverage, including personal injury, bodily injury, broad form property damage, automobile, Premises operations hazard, contractual liability, and products and completed operations liability, in commercially reasonable amounts. Landlord may satisfy its insurance obligations under this Lease by blanket, umbrella and/or, as to liability coverage in excess of One Million Dollars ($1,000,000), excess liability coverage.

15. WAIVER OF SUBROGATION. Whether any loss or damage to or within the Project, the Building and/or the Premises is due to the negligence of either of the parties hereto, their agents or employees, or any other cause, Landlord and Tenant do each herewith and hereby release and relieve the other from responsibility for, and waive their entire claim of recovery, for (a) any loss or damage to the real or personal property of the other located anywhere in the

Project and including the Project itself, arising out of or incident to the occurrence of any of the perils which are covered by any "all risk" or "causes of loss - special form" insurance policy covering the Project; or (b) loss resulting from business interruption at the Premises, arising out of or incident to the occurrence of any of the perils which are covered by any business interruption insurance policy covering the Project. To the extent that such risks under Clauses (a) and (b) are, in fact, covered by insurance, each party shall cause its insurance carriers to consent to such waiver and to waive all rights of subrogation against the other party. Notwithstanding the foregoing, no such release shall be effective unless the aforesaid insurance policy or policies shall expressly permit such a release or contain a waiver of the carrier's right to be subrogated.

16. CASUALTY. If the Building and/or the Premises are damaged by fire or other perils covered by insurance carried by Landlord, Landlord shall have the following rights and obligations:

(a) *Repair and Restoration*

(1) If the Building and/or the Premises are damaged or destroyed by any such peril, to the extent the cost to repair exceeds fifty percent (50%) of the then full replacement value thereof or the damage thereto is such that the Building and/or the Premises cannot reasonably be repaired, reconstructed and restored within nine (9) months from the date of such damage or destruction, Landlord shall, at its sole option, as soon as reasonably possible thereafter, either (i) commence or cause the commencement of the repair, reconstruction and restoration of the Building and/or the Premises and prosecute or cause the same to be prosecuted diligently to completion, in which event this Lease shall remain in full force and effect; or (ii) within sixty (60) days after such damage or destruction, elect not to so repair, reconstruct or restore the Building and/or the Premises, in which event this Lease shall terminate. In either event, Landlord shall give Tenant written notice of its intention within said sixty (60) day period. If Landlord elects not to restore the Building and/or the Premises, this Lease shall be deemed to have terminated as of the date of such damage or destruction.

(2) If the Building and/or the Premises are partially damaged or destroyed by any such peril, to the extent the cost to repair is fifty percent (50%) or less of the then full replacement value thereof, and if the damage thereto is such that the Building and/or the Premises reasonably may be repaired, reconstructed or restored within a period of nine (9) months from the date of such damage or destruction, then Landlord shall commence or cause the commencement of and diligently complete or cause the completion of the work of repair, reconstruction and restoration of the Building and/or the Premises and this Lease shall continue in full force and effect.

(b) *Uninsured Casualties*. If damage or destruction of the Building and/or the Premises is due to any cause not covered by collectible insurance carried by Landlord at the time of such damage or destruction, Landlord may elect to terminate this Lease if the cost to repair exceeds One Hundred Fifty Thousand Dollars ($150,000.00). If the repairing or restoring of the damage is delayed or prevented for longer than nine (9) months after the occurrence of such damage or destruction by reason of weather, acts of God, war, governmental restrictions, inability to procure the necessary labor or materials, or any cause that is beyond the reasonable control of Landlord, Landlord may elect to be relieved of its obligation to make such repairs or restoration and terminate this Lease. Further, Landlord shall not have any obligation to repair, reconstruct or restore the Premises and may terminate this Lease when the damage resulting from any casualty covered under this Section 16 occurs during the last twelve (12) months of the Term if such damage cannot be repaired within thirty (30) days from the date of such damage.

(c) *Tenant's Termination Right*. If the work of repair, reconstruction and restoration in connection with damage or destruction of the Building and/or Premises initially affects more than twenty-five percent (25%) of the floor area of the Premises and shall require a period longer than six (6) months to complete, then Tenant may elect to terminate this Lease, provided that Tenant shall give written notice to Landlord of its intention within thirty (30) days after the date it is advised of such repair period.

(d) *Termination of Lease*. Upon any termination of this Lease under any of the provisions of this Section 16, Landlord and Tenant shall each be released without further obligation to the other from the date possession of the Premises is surrendered to Landlord or such other date as is mutually agreed upon by Landlord and Tenant except for payments or other obligations which have theretofore accrued and are then unpaid or unperformed.

(e) *Rent Abatement*. In the event of repair, reconstruction and restoration by or through Landlord as herein provided, the Basic Rent and Tenant's Proportionate Share of the Operating Expense Increase payable under this Lease shall be abated proportionately to the degree to which Tenant's use of the Premises is materially impaired during the period from the date of such damage or destruction through the date of the Landlord's substantial completion of its repair of the Premises. Tenant shall not be entitled to any compensation or damages for loss of the use of the whole or any part of the Premises and/or any inconvenience or annoyance occasioned by such damage, repair, reconstruction or restoration, nor shall Tenant be entitled to any insurance proceeds, including those in excess of the amount required by Landlord for such repair, reconstruction or restoration. Tenant shall not be released from any of its obligations under this Lease due to damage or destruction of the Building and/or the Premises except to the extent and upon the conditions expressly stated in this Section 16.

(f) *Extent of Repair Obligation*. If Landlord is obligated to or elects to repair or restore as herein provided, Landlord shall be obligated to make repair or restoration only of those portions of the Building and the Premises which were originally provided at Landlord's expense, and the repair and restoration of items not provided at Landlord's expense shall be the obligation of Tenant. Tenant shall assign and deliver to the Landlord any insurance proceeds payable to or received by Tenant in connection with the Tenant Improvements or any other improvements initially constructed or installed by the Landlord and insured by the Tenant pursuant to Section 14 hereof, and Landlord shall thereafter, to the extent that it receives any such insurance proceeds, repair and restore such Tenant Improvements and other improvements.

(g) *Waiver*. The provisions of California Civil Code § 1932(2) and § 1933(4), which permit termination of a lease upon destruction of the Premises, are hereby waived by Tenant; and the provisions of this Section 16 shall govern in case of such destruction.

17. CONDEMNATION.

(a) *Complete Taking*. If the whole of the Project, the Building or the Premises or so much thereof shall be taken by condemnation or in any other manner for any public or quasi-public use or purpose so that a reasonable amount of reconstruction will not result in the Premises being reasonably suitable for Tenant's continued occupancy, this Lease and the term and estate hereby granted shall terminate as of the date that possession of the Project, the Building or the Premises is so taken (herein called "**Date of the Taking**"), and the Basic Rent and other sums payable hereunder shall be prorated and adjusted as of such termination date.

(b) *Partial Taking*. If only a part of the Building, the Project or the Premises shall be so taken and the remaining part thereof after reconstruction is reasonably suited for Tenant's continued occupancy, this Lease shall be unaffected by such taking, except that if the taking affects the Building and/or the Project in addition to the Premises, Landlord may, at its option, terminate this Lease by giving Tenant written notice to that effect within sixty (60) days after the Date of the Taking. In such event, this Lease shall terminate on the date that such notice from the Landlord to Tenant shall be given, and the Basic Rent and other sums payable hereunder shall be prorated and adjusted as of such termination date. Upon a partial taking after which this Lease continues in force as to any part of the Premises, the Basic Rent and other sums payable hereunder shall be adjusted according to the rentable area remaining.

(c) *Award*. Landlord shall be entitled to receive the entire award or payment in connection with any taking without deduction therefrom for any estate vested in Tenant by this Lease, and Tenant shall receive no part of such award, including any award for the "leasehold bonus value" of this Lease. Tenant hereby expressly assigns to Landlord all of its right, title and interest in and to every such award or payment.

(d) *Waiver*. Except as may be otherwise provided herein, Tenant hereby waives and releases any right to terminate this Lease under Sections 1265.120 and 1265.130 of the California Code of Civil Procedure or under any similar law, statute or ordinance now or hereafter in effect relative to eminent domain, condemnation or takings.

18. ASSIGNMENT OR SUBLETTING.

(a) *Landlord's Consent*. Without the express prior written consent of Landlord, Tenant shall not directly or indirectly, voluntarily or by operation of law, sell, assign, encumber, pledge, or otherwise transfer or hypothecate all of its interest in or rights with respect to the Premises (collectively, "**Assignment**"), or permit all or any portion of the Premises to be occupied by anyone other than Tenant or sublet all or any portion of the Premises or transfer a portion of its interest in or rights with respect to the Premises (collectively, "**Sublease**").

(b) *Notice to Landlord*. If Tenant desires to enter into an Assignment or a Sublease, Tenant shall give written notice to Landlord of its intention to do so (the "**Transfer Notice**"), containing (i) the name of the proposed assignee or subtenant (collectively, "**Transferee**"), (ii) the nature of the proposed Transferee's business to be carried on in the Premises, (iii) the material terms of the proposed Assignment or Sublease, including, without limitation, the commencement and expiration dates thereof and the rent payable thereunder, (iv) the portion of the Premises proposed to be subleased (the "**Transfer Space**"), and (v) the most recent financial statement or other equivalent financial information reasonably available to Tenant concerning the proposed Transferee. Within fifteen (15) days after Landlord's receipt of the Transfer Notice, Landlord shall, by written notice to Tenant, elect to (1) consent to the Sublease or Assignment, or (2) disapprove the Sublease or Assignment; provided, however, that Landlord agrees not to unreasonably withhold its consent to the Sublease or Assignment. Landlord's consent shall not be deemed to have been unreasonably withheld if the proposed sublessee or assignee is a new concern with no previous business history or if the proposed sublessee or assignee intends to use the Premises (x) for executive suites or any other use inconsistent with Section 6 or the operation of a first-class office building or (y) in a manner which would increase the use of, or the possibility of disturbance of, Hazardous Substances on the Property. Landlord's failure to make such election within fifteen (15) days after Landlord's receipt of the Transfer Notice shall be deemed to be Landlord's disapproval of the proposed Sublease or Assignment.

(c) *Permitted Transfers*. If Landlord consents to any Sublease or Assignment as set forth in Section 18(b):

(1) Tenant may thereafter, within ninety (90) days after Landlord's consent, enter into such Assignment or Sublease, but only with the party and upon substantially the same terms as set forth in the Transfer Notice;

(2) In the case of a Sublease during such times as Tenant is no longer then occupying at least an aggregate of five thousand (5,000) usable square feet within the Premises, Tenant shall pay to Landlord monthly, together with monthly installments of rent hereunder, fifty percent (50%) of the difference between (x) any and all sums payable to Tenant in connection with such Sublease (including key money, bonus money and any payment in excess of fair market value for services rendered by Tenant in connection with such Sublease or for assets, fixtures, inventory, equipment or furniture transferred by Tenant in connection with such Sublease), minus (y) the sum of the proportionate amount (on a rentable square footage basis) of Basic Rent payable by Tenant under this Lease for the space covered by such Sublease plus any actual and reasonable out-of-pocket costs incurred by the Tenant in connection with such Sublease (including brokerage commissions and legal fees);

(3) In the case of an Assignment, Tenant shall pay to Landlord, as and when received, fifty percent (50%) of any transfer or assignment fee, purchase price or other consideration received by Tenant in connection with the Assignment attributable to the value of this Lease, net of any out-of-pocket expenses incurred by Tenant in connection with such Assignment;

(4) Any Sublease or Assignment shall be subject to all of the provisions of this Lease, and Landlord's consent to any Sublease or Assignment shall not be construed as a consent to any terms thereof which conflict with any of the provisions of this Lease except to the extent that Landlord specifically agrees in writing to be bound by such conflicting terms; and

(5) No Transferee shall have the right to exercise any right or option under this Lease to lease additional space, extend the Term, or terminate this Lease.

(d) *Continuing Liability*. Tenant shall not be relieved of any obligation to be performed by Tenant under this Lease, including the obligation to obtain Landlord's consent to any other Assignment or Sublease, regardless of whether Landlord consented to any Assignment or Sublease. Any Assignment or Sublease that fails to comply with this Section 18 shall be void and, at the option of Landlord, shall constitute an Event of Default by Tenant under this Lease. The acceptance of Basic Rent or other sums by Landlord from a proposed Transferee shall not constitute Landlord's consent to such Assignment or Sublease.

(e) *Assumption by Transferee*. Each Transferee under an Assignment shall assume all obligations of Tenant under this Lease and shall be and remain liable jointly and severally with Tenant for the payment of Basic Rent, additional rent and other charges, and for the performance of all other provisions of this Lease. Each Transferee under a Sublease, other than Landlord, shall be subject to this Lease. No Assignment shall be binding on Landlord unless Landlord shall receive a counterpart of the Assignment and an instrument in recordable form that contains a covenant of assumption by the Transferee reasonably satisfactory in substance and form to Landlord and consistent with the requirements of this Section 18 but the failure of the Transferee to execute such instrument shall not release the Transferee from its liability as set forth above. Tenant shall reimburse Landlord, within fifteen (15) days after Tenant's receipt of an invoice therefor, for any reasonable out-of-pocket costs that Landlord may incur in connection with any proposed Assignment or Sublease, including Landlord's reasonable attorneys' fees and the costs of investigating the acceptability of any proposed Transferee, not to exceed $2,000 per Sublease or Assignment.

(f) *Default; Waiver*. Any Assignment or Sublease in violation of this Section 18 shall be void and, at the option of Landlord, shall constitute a material default by Tenant under this Lease. The acceptance of rent or additional charges by Landlord from a purported assignee or sublessee shall not constitute a waiver by Landlord of the provisions of this Section 18.

(g) *Change in Control*. Any sale or other transfer, including by consolidation, merger or reorganization, of a majority of the voting stock of Tenant, if Tenant is a corporation (other than a sale of the majority of the stock of a publicly traded company in normal open market transactions), or any sale or other transfer of a majority of or a controlling interest in the partnership interests in Tenant, if Tenant is a partnership, or any sale or other transfer of a majority of or a controlling interest in the membership interests in Tenant, if Tenant is a limited liability company, or any sale or other transfer of a majority of the beneficial interests in Tenant or of any controlling interest in Tenant, if Tenant is a trust or other type of entity, shall be an Assignment for purposes of this Section 18. As used in this Section 18, the term "**Tenant**" shall also mean any entity which has guaranteed Tenant's obligations under this Lease or any entity which directly or indirectly owns a majority of the voting stock or partnership or limited liability company or other beneficial interest of Tenant, and the prohibition hereof shall be applicable to any sales or transfers of the stock or partnership or limited liability company or other beneficial interest of said guarantor or majority owner.

19. SUBORDINATION. Tenant agrees that this Lease is and shall be subordinate to any mortgage, deed of trust, ground lease, underlying lease or other prior lien (hereinafter "**Prior Lien**") that may heretofore be placed upon the Project or the Building, and all renewals, replacements and extensions thereof. Landlord hereby warrants that as of the date hereof, there is no Prior Lien encumbering the Project or the Building. If any Prior Lien holder wishes to have this Lease prior to its Prior Lien, then and in such event, upon such Prior Lien holder's notifying Tenant to that effect, this Lease shall be deemed prior to the Prior Lien. Landlord shall have the right to hereafter cause this Lease to be subordinated to any mortgage, deed of trust, ground lease or underlying lease that may hereafter be placed upon the Project or Building (in which case the same shall be deemed a "Prior Lien" for purposes of this Lease), provided that the holder of such instrument concurrently provides Tenant with a commercially reasonable non-disturbance agreement. If any ground lease or underlying lease terminates for any reason or any mortgage or deed of trust is foreclosed or a conveyance in lieu of foreclosure is made for any reason, Tenant shall, notwithstanding any subordination, attorn to and become the tenant of the successor in interest to Landlord, provided that such successor in interest recognizes the interest of Tenant under this Lease if no default under this Lease then exists. Within fifteen (15) days of presentation, Tenant shall execute any documents which any such Prior Lien holder may require to effectuate the provisions of this Section 19 provided that any such document does not modify Tenant's rights or obligations hereunder in any monetary respect or otherwise in any material respect and provided further that in the event of any subordination of this Lease to a Prior Lien, the holder of such Prior Lien concurrently provides Tenant with a commercially reasonable non-disturbance agreement.

20. ESTOPPEL CERTIFICATE. Tenant will, upon ten (10) business days prior request by Landlord, execute, acknowledge and deliver to Landlord a statement in writing executed by Tenant, substantially in the form of Exhibit D attached hereto, certifying, among other things, the date of this Lease, that this Lease is unmodified and in full force and effect (or, if there have been modifications, that this Lease is in full force and effect as modified, and setting forth such modifications) and the date to which the Basic Rent and additional rent and other sums payable hereunder have been paid, and either stating that to the knowledge of Tenant no default exists hereunder on the part of Landlord or Tenant or specifying each such default of which Tenant may have knowledge and such other matters as may be reasonably requested by Landlord. The parties agree and intend that any such statement by Tenant may be relied upon by any prospective purchaser or mortgagee of the Building or the Project. Tenant's failure to timely deliver such a statement shall be deemed to be an acknowledgment by Tenant that this Lease is in full force and effect without modification (except as set forth by Landlord), there are no uncured defaults under this Lease by Landlord and no more than one monthly installment of Basic Rent and additional rent and other sums payable hereunder have been paid in advance.

21. SERVICES.

(a) *Standard Services*. Landlord shall maintain the public and common areas of the Project and the Building, such as lobbies, stairs, corridors and restrooms, in good order and condition except for damage occasioned by the acts or omissions of Tenant Parties, which shall be repaired at Tenant's sole cost and expense except to the extent that the cost of such repairs in covered by Landlord's insurance. Landlord shall provide janitorial services to the Premises in accordance with customary practices for comparable "full service" office buildings in the vicinity of the Project. Landlord shall furnish the Premises with electricity for lighting and operation of low power usage office machines and elevator service at all times during the Term. Landlord shall furnish the Premises with heating or normal office air conditioning between the hours of 7:00 a.m. and 6:00 p.m., Monday through Friday, except for legal holidays, and between the hours of 9:00 a.m. and 12:00 p.m. on Saturday. Air conditioning units and electricity therefor or special air conditioning requirements, such as for any computer centers, and after-hours heating and air conditioning shall be at Tenant's expense at an hourly rate established by the Landlord in its reasonable discretion from time to time consistent with market rates charged by owners of other Class A office buildings in the vicinity of the Project for such after-hours usage. After hours heating and air conditioning as so charged by Landlord to Tenant shall be payable by the Tenant as Additional Rent concurrently with the payment of Basic Rent hereunder. Tenant shall be solely responsible for the repair and maintenance of any separate heating, ventilating, air conditioning or other equipment installed in the Premises by the Tenant (with the Landlord's consent) or by the Landlord as part of the Tenant Improvements. Landlord shall also provide lighting replacement for Landlord-furnished lighting, toilet room supplies, window washing with reasonable frequency and customary janitorial service. Landlord shall not be liable to Tenant for any loss or damage caused by or resulting from any variation, interruption or failure of said services due to any cause whatsoever; and no temporary interruption or failure of such services incident to the making of repairs, Alterations or improvements due to accident or strike or conditions or events not under Landlord's control shall be deemed an eviction of Tenant or relieve Tenant from any of Tenant's obligations hereunder. However, notwithstanding anything to the contrary contained in this Lease, during the Term of the Lease, if Tenant is actually prevented from using all or a material portion of the Premises as a result of (i) an interruption in essential utility services to the Premises, (ii) Landlord's actions in entering upon the Premises (other than in exercising any remedy or curing any Tenant failure to perform in accordance with this Lease), or (iii) Landlord's failure to perform repair work required to be performed by Landlord under this Lease within the time for performance required under this Lease, and which prevention from use is not cured by Landlord within three (3) consecutive business days following Landlord's receipt of written notice thereof from Tenant stating Tenant's intent to receive an abatement, then Basic Rent and Tenant's Proportionate Share of the Operating Expense Increase payable under this Lease shall thereafter be equitably abated based upon the portion of the Premises which Tenant is so prevented from using, until and to the extent that Tenant is no longer so prevented from using such portion of the Premises as a result of the applicable item described in clause (i), (ii) or (iii) above. Notwithstanding the foregoing, the provisions of Section 16 above and not the provisions of the immediately preceding sentence shall govern in the event of casualty damage to the Premises or Project, and the provisions of Section 17 above and not the provisions of the immediately preceding sentence shall govern in the event of condemnation of all or a part of the Premises or Project.

(b) *Overstandard Use.* Tenant shall not, without the Landlord's prior written consent, use heat-generating machines, machines other than normal office machines, or equipment or lighting other than the Building standard lights located in the Premises, which may affect the temperature otherwise maintained by the air conditioning system or increase the water normally furnished for the Premises by Landlord. If such consent is given, Landlord shall have the right to install supplementary air conditioning units or other facilities in the Premises, including supplementary or additional metering devices, and the cost thereof, including the cost of installation, operation and maintenance, increased wear and tear on existing equipment and other similar charges, together with an administrative fee in the amount set forth in Section 8(c), shall be paid by Tenant to Landlord upon billing by Landlord. If Tenant uses water or electricity in excess of that supplied by Landlord pursuant to subsection (a) above, Tenant shall pay to Landlord, upon billing, the cost of such excess consumption, the cost of the installation, operation and maintenance of equipment which is installed in order to supply such excess consumption, and the cost of the increased wear and tear on existing equipment caused by such excess consumption; and Landlord may install devices to separately meter any increased use and in such event Tenant shall pay the increased cost directly to Landlord, on demand, including the cost of such additional metering devices (including installment costs).

22. SIGNS AND ADVERTISING. Landlord shall provide Tenant, at Landlord's sole cost and expense, with Building standard signage (as such standard is established from time to time by Landlord) on the Building directory in the lobby of the Building. Tenant shall not erect or install or otherwise utilize signs, lights, symbols, canopies, awnings, window coverings or other advertising or decorative matter (collectively, "**Signs**") on the windows, walls or exterior doors or otherwise visible from the exterior of the Premises without first (a) submitting its plans to Landlord and obtaining Landlord's written approval thereof and (b) obtaining any required approval of any applicable governmental authority with jurisdiction at Tenant's sole cost and expense. All Signs approved by Landlord shall be professionally designed and constructed in a first-class workmanlike manner. Landlord shall have the right to promulgate from time to time additional reasonable rules, regulations and policies relating to the style and type of said advertising and decorative matter which may be used by any occupant, including Tenant, in the Building, and may change or amend such rules and regulations from time to time as in its discretion it deems advisable. Tenant agrees to abide by such rules, regulations and policies. At the expiration or earlier termination of this Lease, all such signs, lights, symbols, canopies, awnings or other advertising or decorative matter attached to or painted by Tenant upon the Premises, whether on the exterior or interior thereof, shall be removed by Tenant at its own expense, and Tenant shall repair any damage or injury to the Premises or the Building, and correct any unsightly condition, caused by the maintenance and removal thereof.

23. PARKING. Subject to the rules and regulations of the City and County where the Project is located, Tenant shall have the right to use the parking facilities for the Project in common with other tenants, guests and invitees of the Project during the Term of the Lease, subject to the rules and regulations applicable to the parking facilities, including, without limitation, hours of operation. In addition, Landlord shall reasonably designate four (4) single, reserved parking spaces within the Project parking facilities for use by Tenant's employees and visitors which shall be reasonably proximate to the Building entrance and which shall be identified by Landlord, at Landlord's cost, with signage indicating that such parking spaces are reserved for use by Tenant's visitors in a manner reasonably acceptable to Tenant. Landlord shall maintain the signage for such reserved parking spaces throughout the Term in good condition and repair. All parking which Tenant is entitled to use pursuant hereto shall be provided free of charge during the Term (and if Landlord institutes any paid parking system, Tenant shall be entitled to validations for such paid parking, free of charge). Access to and from the parking facilities shall be available in accordance with the Landlord's rules and regulations established therefor from time to time.

24. RULES AND REGULATIONS. Tenant agrees to observe and be bound by the Rules and Regulations applicable to the Project, a copy of which is attached hereto as Exhibit E. Landlord reserves the right to amend said Rules and Regulations as Landlord in its judgment may from time to time deem to be necessary or desirable for the safety, care and cleanliness of the Project and the preservation of good order therein, and Tenant agrees to comply therewith. Landlord may make concessions requested by a tenant without granting the same concessions to any other tenant. To the extent the Rules and Regulations conflict with this Lease, this Lease shall control.

25. TIME. Time is of the essence of this Lease.

26. QUIET ENJOYMENT. Landlord covenants to control its activities and personnel such that if and so long as Tenant pays the rent and performs the covenants contained in this Lease, Tenant shall hold and enjoy the Premises peaceably and quietly, subject to the provisions of this Lease.

27. DEFAULTS AND REMEDIES.

(a) *Defaults*. The occurrence of any one or more of the following events shall constitute a default hereunder by Tenant (each an "**Event of Default**"):

(1) The failure by Tenant to make any payment of Basic Rent, additional rent, other charges or any other payment required to be made by Tenant hereunder, as and when due, where such failure shall continue for a period of ten (10) days after written notice thereof from Landlord to Tenant; provided, however, that any such notice shall be in lieu of, and not in addition to, any notice required under California Code of Civil Procedure § 1161 regarding unlawful detainer actions.

(2) The failure by Tenant to observe or perform any of the express or implied covenants or provisions of this Lease to be observed or performed by Tenant, other than as specified in Section 27(a) above, where such failure shall continue for a period of thirty (30) days after written notice thereof from Landlord to Tenant. Any such notice shall be in lieu of, and not in addition to, any notice required under California Code of Civil Procedure § 1161 regarding unlawful detainer actions. If the nature of Tenant's default (other than a default specified in Section 27(a) above) is such that more than thirty (30) days are reasonably required for its cure, then Tenant shall not be deemed to be in default if Tenant shall commence such cure within said thirty (30) day period and thereafter diligently prosecute such cure to completion.

(3) Any of the following: (i) The making by Tenant of any general assignment for the benefit of creditors; (ii) the filing by or against Tenant of a petition to have Tenant adjudged a bankrupt or a petition for reorganization or arrangement under any law relating to bankruptcy (unless, in the case of a petition filed against Tenant, the same is dismissed within thirty (30) days); (iii) the appointment of a trustee or receiver to take possession of substantially all of Tenant's assets located at the Premises or of Tenant's interest in this Lease, where possession is not restored to Tenant within thirty (30) days; or (iv) the attachment, execution or other judicial seizure of substantially all of Tenant's

assets located at the Premises or of Tenant’s interest in this Lease where such seizure is not discharged within thirty (30) days.

(b) *Remedies*. If an Event of Default exists, in addition to any other remedies available to Landlord at law or in equity, Landlord shall have the following rights and remedies:

(1) The right to terminate the Lease and pursue its rights and remedies provided by California Civil Code Section 1951.2, in which event Landlord may recover

(A) The worth at the time of award of any unpaid rent which had been earned at the time of such termination; plus

(B) The worth at the time of award of the amount by which the unpaid rent which would have been earned after termination until the time of award exceeds the amount of such rental loss that Tenant proves could be reasonably avoided; plus

(C) The worth at the time of award of the amount by which the unpaid rent for the balance of the Term after the time of award exceeds the amount of such rental loss that Tenant proves could have been reasonably avoided; plus

(D) Any other amount necessary to compensate Landlord for all the detriment proximately caused by Tenant’s failure to perform its obligations under this Lease or which in the ordinary course of things would be likely to result therefrom, specifically including, but not limited to, brokerage commissions and advertising expenses incurred, expenses of remodeling the Premises or any portion thereof for a new tenant, whether for the same or a different use, and any special concessions made to obtain a new tenant; plus

(E) At Landlord’s election, such other amounts in addition to or in lieu of the foregoing as may be permitted from time to time by applicable law.

The term “rent” as used hereinabove shall be deemed to be and to mean all sums of every nature required to be paid by Tenant pursuant to the terms of this Lease, whether to Landlord or to others. As used herein, the “worth at the time of award” shall be computed by allowing interest at the rate of 12%, but in no case greater than the maximum amount of such interest permitted by law. As used herein, the “worth at the time of award” shall be computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent (1%).

(2) The rights and remedies provided by California Civil Code Section 1951.4, that allow Landlord to continue this Lease in effect and to enforce all of its rights and remedies under this Lease, including the right to recover Basic Rent, additional rent and other charges as they become due, for so long as Landlord does not terminate Tenant’s right to possession. Acts of maintenance or preservation, efforts to relet the Premises or the appointment of a receiver upon Landlord’s initiative to protect its interest under this Lease shall not constitute a termination of Tenant’s right to possession;

(3) The right to enter the Premises and remove therefrom all persons and property, store such property in a public warehouse or elsewhere at the cost of and for the account of Tenant, and sell such property and apply the proceeds therefrom pursuant to applicable California law; and

(4) The right to take steps necessary or appropriate to have a receiver appointed for Tenant in order to take possession of the Premises and apply any rental collected and exercise all other rights and remedies granted to Landlord.

(c) *Reentry*. If an Event of Default exists, Landlord shall also have the right, with or without terminating this Lease, to re-enter the Premises and remove all persons and property from the Premises; such property may be removed and stored in a public warehouse or elsewhere at the cost of and for the account of Tenant. No re-entry or taking possession of the Premises by Landlord pursuant to this Section 27(c) shall be construed as an election to terminate this Lease unless a written notice of such intention is given to Tenant or unless the termination thereof is decreed by a court of competent jurisdiction.

(d) *Remedies Cumulative; Waiver*. All rights, options and remedies of Landlord contained in this Lease or provided by law or in equity shall be construed and held to be cumulative, and no one of them shall be exclusive of the other. No waiver of any default hereunder shall be implied from any acceptance by Landlord of any Basic Rent, additional rent or other charges due hereunder or any omission by Landlord to take any action on account of such default, and no express waiver shall affect any default other than as specified in said waiver. The consent or approval of Landlord to or of any act by Tenant requiring Landlord's consent or approval shall not be deemed to waive or render unnecessary Landlord's consent or approval to or of any subsequent similar acts by Tenant.

28. TRANSFER OF LANDLORD'S INTEREST. In the event of any transfer or transfers of Landlord's interest in the Project or the Building, other than a transfer for security purposes only, Tenant agrees that Landlord shall be automatically relieved of any and all obligations and liabilities on the part of Landlord accruing from and after the date of such transfer and Tenant agrees to attorn to the transferee.

29. RIGHT TO PERFORM. If Tenant shall fail to pay any sum of money, other than Basic Rent required to be paid by it hereunder, or shall fail to perform any other act on its part to be performed hereunder, and such failure shall continue for ten (10) days after written notice thereof by Landlord, Landlord may, but shall not be obligated so to do, and without waiving or releasing Tenant from any obligations of Tenant, make any such payment or perform any such other act on Tenant's part to be made or performed as provided in this Lease. Tenant shall reimburse Landlord for all costs incurred in connection with such payment or performance immediately upon demand.

30. IMPROVEMENTS.

(a) *Delivery of Premises*. The parties hereby agree and acknowledge that the Premises is currently vacant and that by the execution and delivery of this Lease, Landlord shall be deemed to have delivered possession of the Premises to Tenant. The improvement of the

Premises with the "**Tenant Improvements**" by Tenant shall be governed by the provisions of Exhibit F attached hereto.

(b) *Tenant Improvement Allowance*. Landlord shall provide Tenant an allowance for tenant improvements to the Premises in an amount not to exceed the Tenant Improvement Allowance specified in Paragraph 19 of the Basic Lease Information. The Tenant Improvement Allowance shall be used in accordance with the terms and conditions of Exhibit F attached hereto.

(c) *Acceptance of Premises*. Landlord shall have no obligation whatsoever to construct leasehold improvements for Tenant or to repair or refurbish the Premises, except as specifically set forth in this Section 30 and except as expressly provided in Exhibit F. Landlord or Landlord's agents have made no representations or promises with respect to the Project, the Building, the Premises or this Lease except as expressly set forth herein. The taking of possession of the Premises by Tenant shall be conclusive evidence that Tenant accepts the same "as is" and that the Premises, the Project and the Building are suited for the use intended by Tenant and were in good and satisfactory condition at the time such possession was taken, subject to the provisions of Exhibit F. Tenant represents and warrants to Landlord that (i) its sole intended use of the Premises is for general office use which has no special requirements, including but not limited to, special security requirements, (ii) it does not intend to use the Premises for any other purpose, and (iii) prior to executing this Lease it has made such investigations as it deems appropriate with respect to the suitability of the Premises for its intended use and has determined that the Premises is suitable for such intended use.

31. NOTICES. All notices under this Lease shall be in writing and sent to the parties at the following addresses or at such other address as any party hereto may designate to the other by notice delivered as provided herein:

To Landlord:

To Tenant: Prior to Tenant's Move-In to the Premises:
Redwood Trust, Inc.
591 Redwood Highway, Suite 300
Mill Valley, California 94941
Attention: George Bull
Telephone No.: (415) 389-7373
Facsimile No.: (415) 381-1773

Following Tenant's Move-In to the Premises:
Redwood Trust, Inc.
One Belvedere Place, Suite 300
Mill Valley, California 94941
Attention: George Bull
Telephone No. and Facsimile No. to be provided by Tenant upon move-in to Premises

Any such notices shall be sent by (i) U.S. certified mail, postage prepaid, return receipt requested, in which case notice shall be deemed delivered three business days after timely deposit in the mail, (ii) a nationally recognized overnight courier, in which case notice shall be deemed delivered one business day after timely deposit with such courier; (iii) personally delivered, in which case notice shall be deemed delivered upon receipt, or (iv) electronic communication, whether by telex, telegram or telecopying, in which case notice shall be deemed delivered on the date of confirmed dispatch.

32. ATTORNEYS' FEES. If either party places the enforcement of this Lease or any part hereof, or the collection of any Basic Rent, additional rent or other charges due or to become due hereunder, or recovery of the possession of the Premises, in the hands of an attorney, or files suit upon the same, the non-prevailing (or defaulting) party shall pay the other party's reasonable legal and attorneys' fees, costs and expenses, including legal and attorneys' fees, costs and expenses incurred in connection with any appeals and any bankruptcy or insolvency proceedings involving Tenant or this Lease. Any such attorneys' fees and other expenses incurred by either party in enforcing a judgment in its favor under this Lease shall be recoverable separately from and in addition to any other amount included in such judgment, and such attorneys' fees obligation is intended to be severable from the other provisions of this Lease and to survive and not be merged into any such judgment. The terms "attorneys' fees" and "attorneys' fees, costs and expenses" shall mean the fees, costs and expenses of counsel to the parties hereto, which may include printing, photostating, duplicating and other expenses, air freight charges, and fees billed for law clerks, paralegals and other persons not admitted to the bar but performing services under the supervision of an attorney, and the costs and fees incurred in connection with the enforcement or collection of any judgment obtained in any such proceeding, and shall include, specifically, all fees, costs and expenses of expert witnesses. For purposes of this Paragraph 32, the term "prevailing party" shall include a prevailing party as defined in California Code of Civil Procedure Section 998.

33. HOLDING OVER. If Tenant holds over after the expiration or earlier termination of the Term without the express prior written consent of Landlord, Tenant shall become a tenant at sufferance only, at a rental rate equal to (a) during the initial thirty (30) days of such holding over, one hundred twenty-five percent (125%) of the Basic Rent in effect upon the date of such expiration, prorated on a daily basis, and (b) following the initial thirty (30) days of such holding over, one hundred one hundred fifty percent (150%) of the Basic Rent in effect upon the date of such expiration, prorated on a daily basis, and in each case otherwise subject to the terms, covenants and conditions herein specified, so far as applicable. Acceptance by Landlord of rent after such expiration or earlier termination shall not result in a renewal of this Lease and shall not waive Landlord's right to bring an unlawful detainer action against Tenant or otherwise remove Tenant from the Premises. If Tenant fails to surrender the Premises upon the expiration of this Lease despite demand to do so by Landlord, Tenant shall indemnify, defend and hold Landlord harmless from all loss or liability, including without limitation, any claim made by any succeeding tenant founded on or resulting from such failure to surrender.

34. SURRENDER OF PREMISES. The voluntary or other surrender of this Lease by Tenant, or a mutual cancellation hereof, shall not work a merger, and shall, at the option of Landlord, operate as an assignment to it of any subleases or subtenancies.

35. NON-WAIVER. Neither the acceptance of rent nor any other act or omission of Landlord at any time or times after the happening of any event authorizing the cancellation or forfeiture of this Lease shall operate as a waiver of any past or future violation, breach or failure to keep or perform any covenant, agreement, term or condition hereof, or deprive Landlord of its right to cancel or forfeit this Lease, upon the notice required by law, at any time that cause for cancellation or forfeiture may exist, or be construed so as to at any future time stop Landlord from promptly exercising any other option, right or remedy that it may have under any term or provision of this Lease.

36. MORTGAGEE PROTECTION. In the event of any default on the part of Landlord, Tenant will give written notice by registered or certified mail to any beneficiary of a deed of trust or mortgagee under a mortgage covering the Project or the Building whose address shall have been furnished to Tenant, and shall offer such beneficiary or mortgagee a reasonable opportunity to cure the default, including time to obtain possession of the Project or the Building by power of sale or a judicial foreclosure, if such should prove necessary to effect a cure.

37. INTENTIONALLY OMITTED.

38. CHANGES TO THE PROJECT. Landlord reserves the right at any time to make changes, alterations, reductions and additions to the Project, including the construction of other buildings or improvements in the Project, the leasing of space to restaurant uses, the building of additional stories on any building, without any liability or responsibility to Tenant. Landlord will not block ingress and egress to the Premises nor access to or use of the parking facilities. No rights to any view or to light or air over any property, whether belonging to Landlord or any other person, are granted to Tenant by this Lease. If at any time any windows of the Premises are temporarily darkened or the light or view therefrom is obstructed by reason of any repairs, improvements, maintenance or cleaning in or about the Project, the same shall be without liability to the Landlord and without any reduction or diminution of Tenant's obligations under this Lease.

39. WAIVER OF JURY TRIAL. EACH PARTY HEREBY WAIVES ANY RIGHT TO A TRIAL BY JURY IN ANY ACTION TO ENFORCE THE SPECIFIC PERFORMANCE OF THIS LEASE, FOR DAMAGES FOR THE BREACH HEREOF, OR OTHERWISE FOR ENFORCEMENT OF ANY REMEDY HEREUNDER. If either party commences litigation against the other for the specific performance of this Lease, for damages for the breach hereof or otherwise for enforcement of any remedy hereunder, the prevailing party shall be entitled to recover from the other party such costs and reasonable attorneys' fees as may have been incurred, including any and all costs incurred in enforcing, perfecting and executing such judgment.

40. OPTIONS TO EXTEND THE TERM.

(a) *Extension Term*. Landlord grants to Tenant the option to extend the Term (the "**Extension Option**") with respect to all (but not less than all) of the rentable area of the Premises leased by Tenant as of the Expiration Date of the Initial Term for an additional period of sixty (60) months (the "**Extension Term**"). The Extension Term shall commence immediately following the Expiration Date of the Initial Term. The Extension Option shall be exercised, if at all, by written notice to Landlord at any time during the Initial Term on or before the date that is nine (9) months prior to the Expiration Date, which notice shall be irrevocable by Tenant. Notwithstanding the foregoing, if an Event of Default exists under this Lease either at the time Tenant exercises the Extension Option or at any time thereafter prior to or upon the commencement of the Extension Term, Landlord shall have, in addition to all of Landlord's other rights and remedies under this Lease, the right to terminate the Extension Option and to cancel unilaterally Tenant's exercise of the Extension Option, in which event the Expiration Date of this Lease shall be and remain the then scheduled Expiration Date, and Tenant shall have no further rights under this Lease to renew or extend the Term.

(b) *Extension Term Rent.*

(1) The Extension Term (individually, a "**Extension Term**") shall be upon and subject to all of the terms, covenants and conditions of this Lease; provided, however, that the Basic Rent for the Extension Term shall be equal to the Fair Market Rental Value. Such Basic Rent shall be determined by Landlord not later than four (4) months prior to the commencement of the Extension Term. Tenant shall send to Landlord a written notice, within twenty (20) days after the date of Landlord's notice setting forth the Fair Market Rental Value for the Extension Term, which notice shall state that Tenant either (x) agrees with Landlord's determination of Fair Market Rental Value for the Extension Term or (y) disagrees with Landlord's determination of Fair Market Rental Value for the Extension Term and elects to resolve the disagreement as provided in Section 40(b)(2) below. If Tenant does not send to Landlord a notice as provided in the previous sentence within the said twenty (20) day period, Landlord's determination of the Fair Market Rental Value shall be determinative. Until the disagreement is resolved as provided in Section 40(b)(2) below, Tenant's monthly payments of Basic Rent shall be in an amount not less than the greater of (x) Tenant's determination of the Fair Market Rental Value and (y) the Basic Rent payable for the twelve (12) month period immediately preceding the commencement of the Extension Term. Within ten (10) business days following the resolution of such dispute by the parties or the decision of the brokers/appraisers, as applicable, one party shall make any necessary payment to the other party in order to adjust the amount previously paid by Tenant during the Extension Term to the Fair Market Rental Value as determined. Notwithstanding anything to the contrary set forth in this Section 40 in no event shall the Basic Rent for the Extension Term be less than the effective Basic Rent payable immediately preceding the commencement of the applicable Extension Term. Tenant shall in any event pay all applicable additional charges with respect to the Premises, in the manner and at the times provided in this Lease, effective upon the commencement of the Extension Term, and notwithstanding any dispute regarding the Basic Rent for the Extension Term.

(2) Any disagreement regarding the Fair Market Rental Value as defined in this Section 40 shall be resolved as follows:

(i) Within twenty (20) days after Tenant's response to Landlord's notice of the Landlord's initial determination of the Fair Market Rental Value, Landlord and

Tenant shall meet no less than two (2) times, at a mutually agreeable time and place, to attempt to resolve any such disagreement.

(ii) If, within the twenty (20) day consultation period described in subsection (i) above, Landlord and Tenant cannot reach an agreement as to the Fair Market Rental Value, they shall each make a separate determination of the Fair Market Rental Value within five (5) business days after the expiration of the said twenty (20) day period, and such determinations shall be submitted to arbitration in accordance with subsection (iii) below; provided that, if only one (1) determination of Fair Market Rental Value is submitted to arbitration within the said five (5) business day period, then such determination shall equal the Basic Rent for the Extension Term and the parties shall not proceed with arbitration.

(iii) If the Basic Rent has not been determined pursuant to the procedures outlined above, Landlord and Tenant shall each appoint one arbitrator who shall be either a real estate broker or MAI appraiser and shall have been active over the five (5) year period ending on the date of such appointment in the leasing of commercial mid-rise and/or high-rise properties in the greater San Francisco metropolitan area. Each such arbitrator shall be appointed within five (5) business days after the expiration of the twenty (20) day period described in subsection (ii) above. The two (2) arbitrators so appointed shall within ten (10) days of the date of appointment of the last appointed arbitrator agree upon and appoint a third arbitrator who shall be qualified under the same criteria set forth hereinabove for qualification of the first two (2) arbitrators. The determination of the arbitrators shall be limited solely to the issue of whether the Landlord's or the Tenant's submitted Fair Market Rental Value is the closest to the actual fair market rental value of the Premises, as determined by the arbitrators. The three (3) arbitrators shall within thirty (30) days of the appointment of the third arbitrator reach a decision as to whether the parties shall use the Landlord's or the Tenant's submitted Fair Market Rental Value as the Basic Rent for the Extension Term, and shall notify Landlord and Tenant thereof. The decision of the majority of the three (3) arbitrators shall be binding upon Landlord and Tenant. If either Landlord or Tenant fails to appoint an arbitrator within the five (5) business day period provided above, then the arbitrator appointed by one of them shall reach a decision, notify Landlord and Tenant thereof, and such arbitrator's decision shall be binding upon Landlord and Tenant. If the two (2) arbitrators fail to agree upon and appoint a third arbitrator within the ten (10) day period provided above, or both parties fail to appoint an arbitrator within the five (5) business day period provided above, then the Landlord shall prepare and submit to Tenant a list of three (3) proposed arbitrators that possess the required qualifications as set forth above; provided that none of such proposed arbitrators nor the firm for which any of them works shall be a current or past affiliate of either the Landlord or the Tenant or currently retained or employed by the Landlord or the Tenant. Within five (5) business days after receipt of such list, the Tenant shall select an arbitrator therefrom and such person shall be the third or single, as the case may be, arbitrator hereunder. If Tenant fails to make such selection with such five (5) business day period, then the Landlord shall select the third or single, as the case may be, arbitrator from such list. Each party shall pay the cost of the arbitrator which it first selects and the parties shall share equally the cost of the third arbitrator.

41. SATELLITE DISH ANTENNA. Tenant shall have a nonexclusive right to install, at Tenant's sole cost and expense, one reasonably sized satellite dish antenna on the roof of the Building for Tenant's personal, nonprofit use, without payment of additional rent therefor. Tenant's rights under this Section 41: (a) are personal to Tenant and not assignable without Landlord's express written consent; (b) shall terminate on the Expiration Date; (c) are subject to the current and future needs of Landlord relating to the operation, maintenance and repair of the Building or the Project, and the prior rights of other tenants; and (d) are subject to the approval of all governmental entities with jurisdiction of such antenna. Landlord hereby grants to Tenant a nonexclusive license to use existing and common area passageways in the Building for ingress to and egress from the roof in connection with the installation and maintenance of the antenna, provided that Tenant coordinates ingress to the roof with Landlord. Tenant shall obey all reasonable requirements imposed by Landlord for the protection of the roof and shall, at Tenant's sole cost and expense, obtain all necessary governmental licenses and permits required for, and comply with all legal requirements (including recorded covenants and restrictions) in connection with, the construction and use of the antenna, including, without limitation, the rules and regulations of the Federal Communications Commission. The antenna shall be deemed to be Tenant's personal property for all purposes under this Lease, and upon termination of this Lease Tenant shall remove the antenna in accordance with the provisions of this Lease. Tenant shall (i) prevent its antenna and the antenna's transmission and frequency from interfering with the transmissions and frequencies of any other antennas or communications systems located on or in the Building or the Project, provided, however, that with respect to any third-party antennas or communications systems installed after the date Tenant first installs its antenna on the roof of the Building Tenant shall only be required to use commercially reasonable efforts to avoid any such interference, (ii) screen the antenna from view as reasonably required by Landlord, and (iii) cooperate with Landlord or third parties in maximizing the use of the roof area not used by Tenant. Landlord shall not be responsible for Tenant's antenna or any interference with its antenna's transmission, frequency, operation or use caused by third parties provided however that Landlord shall use commercially reasonable efforts to enforce any non-interference covenants in any leases with other tenants of the Project. Tenant shall not install any facilities or equipment on the roof or make any alteration to the roof without the prior written consent of Landlord, which consent may be withheld in Landlord's sole discretion. Tenant shall be solely responsible for and shall pay, indemnify, defend and hold harmless Landlord from and against all claims, liabilities, demands, damages, losses, costs and expenses incurred in connection with the installation and use of the antenna.]

42. GENERAL PROVISIONS.

(a) *Entire Agreement.* This Lease contains all of the agreements of the parties, and there are no verbal or other agreements which modify or affect this Lease. This Lease supersedes any and all prior agreements made or executed by or on behalf of the parties hereto regarding the Premises.

(b) *Terms and Headings*. The words "**Landlord**" and "**Tenant**" include the plural as well as the singular, and words used in any gender include all genders. The titles to sections of this Lease are not a part of this Lease and shall have no effect upon the construction or interpretation of any part hereof.

(c) *Successors and Assigns*. All of the covenants, agreements, terms and conditions contained in this Lease shall inure to and be binding upon Landlord and Tenant and their respective permitted successors in interest and assigns.

(d) *No Brokers*. Tenant represents and warrants to Landlord that it has not engaged any broker, finder or other person, except for Tenant's Broker (as defined in Paragraph 23 of the Basic Lease Information) who would be entitled to any commission or fees in respect of the negotiation, execution or delivery of this Lease and shall indemnify, defend and hold harmless Landlord from and against any claim, demand, damage, loss, cost, liability or expense incurred by Landlord as a result of any claim asserted by any such broker, finder or other person, except for Tenant's Broker or Landlord's Broker (as defined in Paragraph 22 of the Basic Lease Information) on the basis of any arrangements or agreements made or alleged to have been made by or on behalf of Tenant. The provisions of this section shall not apply to brokers with whom Landlord has an express written broker agreement. Landlord shall be responsible for paying all leasing commissions due Landlord's Broker and Tenant's Broker in connection with this Lease. Landlord shall also be responsible for any fees payable to Landlord's property manager, GateCapital Properties, LLC, in connection with this Lease.

(e) *Liability of Landlord*. Landlord's obligations and liability to Tenant under this Lease shall be limited solely to Landlord's interest in the Project, and neither Landlord nor any of the members in Landlord, nor any officer, director, shareholder or partner of or in Landlord or any members in Landlord shall have or incur any personal liability whatsoever with respect to this Lease.

(f) *Independent Covenants*. This Lease shall be construed as though the covenants herein between Landlord and Tenant are independent and not dependent and Tenant agrees that if Landlord fails to perform its obligations set forth herein, Tenant shall not be entitled to make any repairs or perform any acts hereunder at Landlord's expense or to any setoff of amounts owing hereunder against Landlord; provided, however, that the foregoing shall in no way impair the right of Tenant to commence a separate action against Landlord for any violation by Landlord of the provisions hereof so long as notice is first given to Landlord and any holder of a mortgage or deed of trust covering the Building or the Project or any portion thereof, and an opportunity is granted to Landlord and such mortgage holder to correct such violations as provided above.

(g) *Waiver of Redemption by Tenant*. Tenant hereby waives, for Tenant and for all those claiming under Tenant, any and all rights now or hereafter existing to redeem by order or judgment of any court or by any legal process or writ, Tenant's right of occupancy of the Premises after any termination of this Lease.

(h) *Severability*. Any provision of this Lease which shall prove to be invalid, void or illegal shall in no way affect, impair or invalidate any other provision hereof, and the remaining provisions hereof shall nevertheless remain in full force and effect.

(i) *Force Majeure*. Except as may be otherwise specifically provided herein, time periods for Landlord's or Tenant's performance under any provisions of this Lease not involving the payment of money shall be extended for periods of time during which the nonperforming party's performance is prevented due to circumstances beyond the party's control, including, without limitation, strikes, embargoes, governmental regulations, acts of God, weather, war or other strife. Tenant hereby waives and releases its right to terminate this Lease under Section 1932(1) of the California Civil Code or under any similar law, statute or ordinance now or hereafter in effect.

(j) *Identification of Tenant*. If more than one person executes this Lease as Tenant:

(1) Each of such persons is jointly and severally liable for the performance of all of the terms, covenants and conditions of this Lease, and

(2) The term "**Tenant**" shall mean each of them jointly and severally. The act or notice from, or notice or refund to, or the signature of any one or more of them, with respect to the tenancy of this Lease, shall be binding upon each and all of the persons executing this Lease as Tenant.

(k) *Examination of Lease*. Submission of this instrument for examination or signature by Tenant does not constitute a reservation of or option to lease, and it is not effective as a lease or otherwise until execution by and delivery to both Landlord and Tenant.

(l) *No Warranty*. In executing and delivering this Lease, Tenant has not relied on any representations, including, but not limited to, any representation as to the amount of any item comprising additional rent or the amount of the additional rent in the aggregate or that Landlord is furnishing the same services to other tenants, at all, on the same level or on the same basis, or any warranty or any statement of Landlord which is not set forth herein or in one or more of the exhibits attached hereto.

(m) *Right to Lease*. Landlord reserves the absolute right to effect such other tenancies in the Project as Landlord in the exercise of its sole business judgment shall determine to best promote the interests of the Building and the Belvedere Place office center. Tenant does not rely on the fact, nor does Landlord represent, that any specific tenant or type or number of tenants shall, during the Term, occupy any space in the Building or the Belvedere Place office center.

(n) *Transportation Management*. Tenant shall fully comply with all present or future governmentally mandated programs intended to manage parking, transportation or traffic in and around the Project, and in connection therewith, Tenant shall take responsible action for the transportation planning and management of all employees located at the Project by working directly with Landlord, any governmental transportation management organization or any other transportation-related committees or entities. Such programs may include, without limitation (i) restrictions on the number of peak-hour vehicle trips generated by Tenant; (ii) increased vehicle occupancy; (iii) implementation of an in-house ridesharing program and an employee transportation coordinator; (iv) working with employees and any Project, Building or area-wide ridesharing program manager; (v) instituting employer-sponsored incentives (financial or in-kind) to encourage employees to rideshare; and (vi) utilizing flexible work shifts for employees.

(o) *Modification for Lender*. If, in connection with Landlord's obtaining construction, interim or permanent financing for the Building or Project, the lender shall request reasonable modifications in this Lease as a condition to such financing, Tenant will not unreasonably withhold, delay or defer its consent thereto, provided that such modifications do not increase the obligations of Tenant hereunder or materially adversely affect the leasehold interest hereby created or Tenant's rights hereunder.

(p) *Recording*. Neither Landlord nor Tenant shall record this Lease nor a short form memorandum hereof without the consent of the other.

(q) *Applicable Laws.* This Lease shall be governed by and construed pursuant to the laws of the State of California.

(r) *Relationship of Parties*. Nothing contained in this Lease shall be deemed or construed by the parties hereto or by any third party to create the relationship of principal and agent, partnership, joint venture or any association between Landlord and Tenant, it being expressly understood and agreed that neither the method of computation of rent nor any act or omission of the parties hereto shall be deemed to create any relationship between Landlord and Tenant other than the relationship of landlord and tenant.

(s) *Landlord's Title*. Landlord's title is and always shall be paramount to the title of Tenant. Nothing herein contained shall empower Tenant to do any act which can, shall or may encumber the title of Landlord.

(t) *Project or Building Name and Signage.* Landlord shall have the right at any time to change the name of the Building or Project and to install, affix and maintain any and all signs on the exterior and on the interior of the Project or Building as Landlord may, in Landlord's sole discretion, desire. Tenant shall not use the name of the Project or the Building (including the name Belvedere Place) or use pictures or illustrations of the Project or the Building in advertising or other publicity, without the prior written consent of the Landlord.

(u) *Survival of Obligations.* All provisions of this Lease which require the payment of money or the delivery of property after the termination of this Lease or require Tenant to indemnify, defend or hold Landlord harmless shall survive the termination of this Lease.

(v) *Authority*. Each individual executing this Lease represents that it has all requisite power and authority to execute and deliver this Lease on behalf of the entity for which it is signing, and by his or her signature, will bind such party to the terms of this Lease.

(w) *Execution in Counterparts.* This Agreement may be executed in any number of counterparts and by different parties hereto in separate counterparts, each of which when so executed shall be deemed to be an original and all of which taken together shall constitute one and the same agreement.

IN WITNESS WHEREOF, the parties hereto have executed this Lease as of the date first above written.

LANDLORD:

TENANT:

REDWOOD TRUST, INC.
a Maryland corporation

By:____________________________
Name:
Title:

By:____________________________
Name:
Title:

Exhibit 11.1
Redwood Trust, Inc.
Computation of Per Share Earnings

	Twelve Months Ended December 31, 2003	Twelve Months Ended December 31, 2002	Twelve Months Ended December 31, 2001
Basic:			
Average common shares outstanding	17,759,346	15,177,449	10,163,581
Total	17,759,346	15,177,449	10,163,581
Net Income	$ 131,713,361	$ 53,893,217	$ 30,162,747
Per Share Amount	$ 7.42	$ 3.55	$ 2.97
Diluted:			
Average common shares outstanding	17,759,346	15,177,449	10,163,581
Net effect of dilutive stock options outstanding during the period — based on the treasury stock method	827,303	481,174	311,183
Total	18,586,649	15,658,623	10,474,764
Net Income	$ 131,713,361	$ 53,893,217	$ 30,162,747
Per Share Amount	$ 7.09	$ 3.44	$ 2.88

EXHIBIT 21

LIST OF SUBSIDIARIES
OF
REDWOOD TRUST, INC.

Subsidiaries	State of Incorporation or Organization
Sequoia Mortgage Funding Corporation	Delaware
Sequoia Mortgage Funding Corporation 2002-A	Delaware
Sequoia Mortgage Funding Corporation 2002-B	Delaware
Sequoia Mortgage Funding Corporation 2003-A	Delaware
Sequoia Mortgage Trust 1	Delaware
Sequoia Mortgage Trust 2	Delaware
Sequoia Mortgage Trust 5	Delaware
Sequoia Mortgage Trust 6	Delaware
Sequoia Mortgage Trust 7	Delaware
Acacia CDO 1, Ltd.	Cayman Islands
Acacia CDO 2, Ltd.	Cayman Islands
Acacia CDO 3, Ltd.	Cayman Islands
RWT Holdings, Inc.	Delaware
Sequoia Residential Funding, Inc.	Delaware
Redwood Financial Services, Inc.	Delaware

EXHIBIT 23

CONSENT OF INDEPENDENT AUDITORS

We hereby consent to the incorporation by reference in the Registration Statements on Forms S-3 (Nos. 33-97398, 333-25643, and 333-98861) and on Forms S-8 (Nos. 333-20253, 333-90592, 333-89302, and 333-893000) of Redwood Trust, Inc. of our report dated March 4, 2004, relating to the consolidated financial statements, which appear in this Form 10-K.

/s/ PricewaterhouseCoopers LLP

San Francisco, California
March 4, 2004

EXHIBIT 31.1 : PRINCIPAL EXECUTIVE OFFICER CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, George E. Bull, certify that:

1. I have reviewed this annual report on Form 10-K of Redwood Trust, Inc.

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) for the registrant and we have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's control over financial reporting.

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 4, 2004

/s/ George E. Bull

George E. Bull
Chief Executive Officer

EXHIBIT 31.2 : PRINCIPAL FINANCIAL OFFICER CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Harold F. Zagunis, certify that:

1. I have reviewed this annual report on Form 10-K of Redwood Trust, Inc.

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) for the registrant and we have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant’s control over financial reporting.

5. The registrant’s other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Date: March 4, 2004

/s/ Harold F. Zagunis

Harold F. Zagunis
Chief Financial Officer

EXHIBIT 32.1: Certification of Chief Executive Officer regarding Form 10-K for year 2003 pursuant to 18 USC Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Annual Report of Redwood Trust, Inc. (the "Company") on Form 10-K for the year ended December 31, 2003, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, George E. Bull, Chief Executive Officer of the Company, certify, pursuant to 18 USC 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 results of operations of the Company.

/S/ George E. Bull

George E. Bull

Chief Executive Officer

March 4, 2004

This Certification is made solely for the purpose of 18 USC Section 1350, subject to the knowledge standard contained therein, and not for any other purpose.

EXHIBIT 32.2: Certification of Chief Financial Officer regarding Form 10-K for year 2003 pursuant to 18 USC Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Annual Report of Redwood Trust, Inc. (the "Company") on Form 10-K for the year ended December 31, 2003, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, George E. Bull, Chief Executive Officer of the Company, certify, pursuant to 18 USC 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 results of operations of the Company.

/S/ Harold F. Zagunis

Harold F. Zagunis

Chief Financial Officer

March 4, 2004

This Certification is made solely for the purpose of 18 USC Section 1350, subject to the knowledge standard contained therein, and not for any other purpose.