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

**FORM 10-Q**

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

**For the Quarterly Period Ended: June 30, 2014**

**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**<br>(State or Other Jurisdiction of Incorporation or Organization) | **68-0329422**<br>(I.R.S. Employer Identification No.) |
|---|---|
| **One Belvedere Place, Suite 300**<br>**Mill Valley, California**<br>(Address of Principal Executive Offices) | **94941**<br>(Zip Code) |

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

**Not Applicable**
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

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

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

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

| Common Stock, $0.01 par value per share | 83,119,423 shares outstanding as of August 4, 2014 |
|---|---|

**REDWOOD TRUST, INC.**
**2014 FORM 10-Q REPORT**
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## PART I. FINANCIAL INFORMATION

**Item 1. Financial Statements**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**

| (In Thousands, Except Share Data) (Unaudited) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| **ASSETS** | | |
| Residential loans, held-for-sale, at fair value | $ 1,107,877 | $ 404,267 |
| Residential loans, held-for-investment | 1,616,504 | 1,762,167 |
| Commercial loans, held-for-sale, at fair value | 50,848 | 89,111 |
| Commercial loans, held-for-investment (includes $71,270 and $0 at fair value) | 417,918 | 343,344 |
| Real estate securities, at fair value | 1,845,067 | 1,682,861 |
| Mortgage servicing rights, at fair value | 71,225 | 64,824 |
| Cash and cash equivalents | 157,079 | 173,201 |
| Total earning assets | 5,266,518 | 4,519,775 |
| Restricted cash | 393 | 398 |
| Accrued interest receivable | 15,109 | 13,475 |
| Derivative assets | 7,514 | 7,787 |
| Deferred securities issuance costs | 11,252 | 13,453 |
| Other assets | 77,764 | 53,640 |
| **Total Assets (1)** | $ 5,378,550 | $ 4,608,528 |
| **LIABILITIES AND EQUITY** | | |
| **Liabilities** | | |
| Short-term debt | $ 1,718,430 | $ 862,763 |
| Accrued interest payable | 7,154 | 6,366 |
| Derivative liabilities | 39,837 | 18,167 |
| Accrued expenses and other liabilities | 42,223 | 48,704 |
| Deferred tax liability | 7,316 | 7,316 |
| Asset-backed securities issued | 1,768,078 | 1,942,962 |
| Long-term debt (includes $66,692 and $0 at fair value) | 546,608 | 476,467 |
| **Total liabilities (1)** | 4,129,646 | 3,362,745 |
| **Equity** | | |
| Common stock, par value $0.01 per share, 180,000,000 shares authorized; 83,080,118 and 82,504,801 issued and outstanding | 831 | 825 |
| Additional paid-in capital | 1,764,386 | 1,760,899 |
| Accumulated other comprehensive income | 167,557 | 148,766 |
| Cumulative earnings | 834,648 | 806,298 |
| Cumulative distributions to stockholders | (1,518,518) | (1,471,005) |
| **Total equity** | 1,248,904 | 1,245,783 |
| **Total Liabilities and Equity** | $ 5,378,550 | $ 4,608,528 |

(1) Our consolidated balance sheets include assets of consolidated variable interest entities (“VIEs”) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At June 30, 2014 and December 31, 2013, assets of consolidated VIEs totaled $2,125,423 and $2,299,576, respectively, and liabilities of consolidated VIEs totaled $1,769,851 and $1,944,911, respectively. See *Note 4* for further discussion.

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

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

| (In Thousands, Except Share Data) (Unaudited) | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| **Interest Income** | | | | |
| Residential loans | $ 13,601 | $ 18,845 | $ 26,259 | $ 36,469 |
| Commercial loans | 11,217 | 9,623 | 21,601 | 19,794 |
| Real estate securities | 33,170 | 29,114 | 65,601 | 54,831 |
| Cash and cash equivalents | 5 | 137 | 8 | 149 |
| Total interest income | 57,993 | 57,719 | 113,469 | 111,243 |
| **Interest Expense** | | | | |
| Short-term debt | (5,142) | (4,686) | (8,969) | (8,494) |
| Asset-backed securities issued | (8,183) | (10,250) | (16,624) | (21,210) |
| Long-term debt | (7,826) | (6,480) | (14,618) | (10,014) |
| Total interest expense | (21,151) | (21,416) | (40,211) | (39,718) |
| **Net Interest Income** | 36,842 | 36,303 | 73,258 | 71,525 |
| Reversal of provision (provision) for loan losses | 315 | 3,272 | (967) | 1,233 |
| **Net Interest Income After Provision** | 37,157 | 39,575 | 72,291 | 72,758 |
| **Noninterest Income** | | | | |
| Mortgage banking activities, net | 6,310 | 48,723 | 6,079 | 94,260 |
| Mortgage servicing rights income (loss), net | (1,777) | 10,547 | (1,171) | 11,568 |
| Other market valuation adjustments, net (1) | (4,121) | (6,258) | (10,260) | (6,561) |
| Realized gains, net | 1,063 | 556 | 2,155 | 12,823 |
| Total noninterest income (loss), net | 1,475 | 53,568 | (3,197) | 112,090 |
| Operating expenses | (22,282) | (24,430) | (42,254) | (44,616) |
| **Net income before provision for income taxes** | 16,350 | 68,713 | 26,840 | 140,232 |
| (Provision for) benefit from income taxes | (333) | (3,140) | 1,510 | (14,049) |
| **Net Income** | $ 16,017 | $ 65,573 | $ 28,350 | $ 126,183 |
| | | | | |
| Basic earnings per common share | $ 0.19 | $ 0.78 | $ 0.33 | $ 1.50 |
| Diluted earnings per common share | $ 0.18 | $ 0.71 | $ 0.32 | $ 1.40 |
| Regular dividends declared per common share | $ 0.28 | $ 0.28 | $ 0.56 | $ 0.56 |
| Basic weighted average shares outstanding | 82,740,012 | 82,123,823 | 82,575,636 | 81,729,014 |
| Diluted weighted average shares outstanding | 85,032,998 | 96,171,713 | 84,994,321 | 91,647,400 |

(1) For the three months ended June 30, 2014, other-than-temporary impairments were $2,915, of which $264 were recognized through the Income Statement, and $2,651 were recognized in Accumulated Other Comprehensive Income. For the three months ended June 30, 2013, other-than-temporary impairments were $1,642, of which none was recognized in Accumulated Other Comprehensive Income.

For the six months ended June 30, 2014, other-than-temporary impairments were $4,585, of which $377 were recognized through the Income Statement, and $4,208 were recognized in Accumulated Other Comprehensive Income. For the six months ended June 30, 2013, other-than-temporary impairments were $1,666, of which none was recognized in Accumulated Other Comprehensive Income.

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

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

| (In Thousands)<br>(Unaudited) | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| **Net Income** | $ 16,017 | $ 65,573 | $ 28,350 | $ 126,183 |
| Other comprehensive income (loss): | | | | |
| Net unrealized gain (loss) on available-for-sale securities | 12,721 | (38,012) | 33,229 | (28,982) |
| Reclassification of unrealized (gain) loss on available-for-sale securities to net income | (454) | (242) | (341) | (12,249) |
| Net unrealized (loss) gain on interest rate agreements | (5,401) | 13,585 | (14,196) | 21,025 |
| Reclassification of unrealized loss on interest rate agreements to net income | 39 | 69 | 99 | 157 |
| Total other comprehensive income (loss) | 6,905 | (24,600) | 18,791 | (20,049) |
| **Total Comprehensive Income** | $ 22,922 | $ 40,973 | $ 47,141 | $ 106,134 |

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

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

**For the Six Months Ended June 30, 2014**

| (In Thousands, Except Share Data) (Unaudited) | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Accumulated Other Comprehensive Income | Cumulative Earnings | Cumulative Distributions to Stockholders | Total |
|---|---|---|---|---|---|---|---|
| **December 31, 2013** | 82,504,801 | $ 825 | $ 1,760,899 | $ 148,766 | $ 806,298 | $ (1,471,005) | $ 1,245,783 |
| Net income | - | - | - | - | 28,350 | - | 28,350 |
| Other comprehensive income | - | - | - | 18,791 | - | - | 18,791 |
| **Issuance of common stock:** | | | | | | | |
| Dividend reinvestment & stock purchase plans | 179,187 | 2 | 3,473 | - | - | - | 3,475 |
| Employee stock purchase and incentive plans | 396,130 | 4 | (6,667) | - | - | - | (6,663) |
| Non-cash equity award compensation | - | - | 6,681 | - | - | - | 6,681 |
| Common dividends declared | - | - | - | - | - | (47,513) | (47,513) |
| **June 30, 2014** | 83,080,118 | $ 831 | $ 1,764,386 | $ 167,557 | $ 834,648 | $ (1,518,518) | $ 1,248,904 |

**For the Six Months Ended June 30, 2013**

| (In Thousands, Except Share Data) (Unaudited) | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Accumulated Other Comprehensive Income | Cumulative Earnings | Cumulative Distributions to Stockholders | Total |
|---|---|---|---|---|---|---|---|
| **December 31, 2012** | 81,716,416 | $ 817 | $ 1,744,554 | $ 138,332 | $ 633,052 | $ (1,376,591) | $ 1,140,164 |
| Net income | - | - | - | - | 126,183 | - | 126,183 |
| Other comprehensive income | - | - | - | (20,049) | - | - | (20,049) |
| **Issuance of common stock:** | | | | | | | |
| Dividend reinvestment & stock purchase plans | 321,120 | 3 | 6,043 | - | - | - | 6,046 |
| Employee stock purchase and incentive plans | 294,200 | 3 | (5,454) | - | - | - | (5,451) |
| Non-cash equity award compensation | - | - | 9,515 | - | - | - | 9,515 |
| Common dividends declared | - | - | - | - | - | (47,095) | (47,095) |
| **June 30, 2013** | 82,331,736 | $ 823 | $ 1,754,658 | $ 118,283 | $ 759,235 | $ (1,423,686) | $ 1,209,313 |

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

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

| (In Thousands) (Unaudited) | Six Months Ended June 30, 2014 | 2013 |
|---|---|---|
| **Cash Flows From Operating Activities:** | | |
| Net income | $ 28,350 | $ 126,183 |
| Adjustments to reconcile net income to net cash used in operating activities: | | - |
| Amortization of premiums, discounts, and securities issuance costs, net | (17,521) | (11,780) |
| Depreciation and amortization of non-financial assets | 232 | 224 |
| Purchases of loans | (3,118,457) | (5,457,558) |
| Proceeds from sales of held-for-sale loans | 2,339,023 | 4,345,361 |
| Principal payments on held-for-sale loans | 12,100 | 5,169 |
| Net settlements of derivatives | (14,873) | 9,784 |
| Provision (reversal of provision) for loan losses | 967 | (1,233) |
| Non-cash equity award compensation expense | 6,681 | 9,515 |
| Market valuation adjustments, net | 14,034 | (84,560) |
| Realized gains, net | (2,155) | (23,854) |
| Net change in: | | |
| Accrued interest receivable and other assets | (23,935) | (10,871) |
| Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities | (10,655) | 61,186 |
| Net cash used in operating activities | (786,209) | (1,032,434) |
| **Cash Flows From Investing Activities:** | | |
| Purchases of loans held-for-investment | (38,991) | (54,539) |
| Proceeds from sales of held-for-investment loans | - | 440 |
| Principal payments on held-for-investment loans | 146,656 | 284,076 |
| Purchases of real estate securities | (126,162) | (0) |
| Proceeds from sales of real estate securities | 1,313 | 22,518 |
| Principal payments on real estate securities | 95,303 | 81,250 |
| Purchase of mortgage servicing rights | (3,054) | - |
| Net change in restricted cash | 5 | (22) |
| Net cash provided by investing activities | 75,070 | 333,723 |
| **Cash Flows From Financing Activities:** | | |
| Proceeds from borrowings on short-term debt | 2,417,438 | 3,989,557 |
| Repayments on short-term debt | (1,561,771) | (3,095,514) |
| Repayments on asset-backed securities issued | (174,861) | (313,848) |
| Deferred securities issuance costs | - | (9,184) |
| Proceeds from issuance of long-term debt | 69,181 | 304,100 |
| Repayments on long-term debt | (685) | (9) |
| Net settlements of derivatives | (1,650) | (5) |
| Net proceeds from issuance of common stock | 1,787 | 3,064 |
| Taxes paid on equity award distributions | (6,909) | (5,741) |
| Dividends paid | (47,513) | (47,095) |
| Net cash provided by financing activities | 695,017 | 825,325 |
| Net (decrease) increase in cash and cash equivalents | (16,122) | 126,614 |
| Cash and cash equivalents at beginning of period | 173,201 | 81,080 |
| Cash and cash equivalents at end of period | $ 157,079 | $ 207,694 |
| | | |
| **Supplemental Cash Flow Information:** | | |
| Cash paid during the period for: | | |
| Interest | $ 38,158 | $ 37,581 |
| Taxes | 1,399 | 1,097 |
| **Supplemental Noncash Information:** | | |
| Real estate securities retained from loan securitizations | $ 85,000 | $ 290,253 |
| Retention of mortgage servicing rights from loan securitizations and sales | 11,976 | 28,614 |
| Transfers from loans held-for-sale to loans held-for-investment | 37,631 | - |
| Transfers from residential loans to real estate owned | 1,832 | 2,687 |

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2014
(Unaudited)

**Note 1. Redwood Trust**

Redwood Trust, Inc., together with its subsidiaries, is a specialty finance company focused on investing in mortgage- and other real estate-related assets and engaging in residential and commercial mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential and commercial mortgage banking activities. We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments.

Our primary sources of income are net interest income from our investment portfolios and noninterest income from our mortgage banking activities. Net interest income consists of the interest income we earn on investments less the interest expense we incur on borrowed funds and other liabilities. Income from mortgage banking activities consists of the profit we seek to generate through the acquisition or origination of loans and their subsequent sale or securitization. References herein to “Redwood,” the “company,” “we,” “us,” and “our” include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires.

Redwood 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.

**Note 2. Basis of Presentation**

The consolidated financial statements presented herein are at June 30, 2014 and December 31, 2013, and for the three and six months ended June 30, 2014 and 2013. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (“GAAP”) in the United States of America — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — and using the Securities and Exchange Commission’s (“SEC”) instructions to Form 10-Q.

***Organization***

For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust (“REIT”). We generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as “the REIT” or “our REIT.” We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as “our operating subsidiaries” or “our taxable REIT subsidiaries” or “TRS.” Our mortgage banking activities are generally carried out through our taxable REIT subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our taxable REIT subsidiaries, and to distribute as dividends at least 90% of the income we generate at our REIT.

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

***Principles of Consolidation***

We apply FASB guidance to determine whether we must consolidate transferred financial assets and variable interest entities (“VIEs”) for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during 2011 (“Residential Resecuritization”), and an entity formed in connection with a commercial securitization we engaged in during 2012 (“Commercial Securitization”). Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained in them, although we are also exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

For financial reporting purposes, the underlying loans and securities owned at the consolidated Sequoia entities, the Residential Resecuritization entity, and the Commercial Securitization entity are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The asset-backed securities (“ABS”) issued to third parties by these entities are shown

**Note 2. Basis of Presentation — (continued)**

under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned at these entities and interest expense on the ABS issued by these entities.

See *Note 4* for further discussion on principles of consolidation.

**Note 3. Summary of Significant Accounting Policies**

***Use of Estimates***

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

***Fair Value Measurements***

Our financial statements include assets and liabilities that are measured at their estimated fair values in accordance with GAAP. A fair value measurement represents the price at which an orderly transaction would occur between willing market participants at the measurement date. We develop fair values for financial assets or liabilities based on available inputs and pricing that is observed in the marketplace. Examples of market information that we attempt to obtain include the following:

- Quoted prices for the same or similar securities;
- Relevant reports issued by analysts and rating agencies;
- The current level of interest rates and any directional movements in relevant indices, such as credit risk indices;
- Information about the performance of mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;
- Indicative prices or yields from broker/dealers (including prices from counterparties under securities repurchase agreements); and,
- Other relevant observable inputs, including nonperformance risk and liquidity premiums.

After considering all available indications of the appropriate rate of return that market participants would require, we consider the reasonableness of the range indicated by the results to determine an estimate that is most representative of fair value.

The markets for many of the loans and securities that we invest in and issue are generally illiquid. Establishing fair values for illiquid assets and liabilities is inherently subjective and is often dependent upon our estimates and modeling assumptions. If we determine that either the volume and/or level of trading activity for an asset or liability has significantly decreased from normal market conditions, or price quotations or observable inputs are not associated with orderly transactions, the market inputs that we obtain might not be relevant. For example, broker or pricing service quotes might not be relevant if an active market does not exist for the financial asset or liability. The nature of the quote (for example, whether the quote is an indicative price or a binding offer) is also evaluated.

In circumstances where relevant market inputs cannot be obtained, increased analysis and management judgment are required to estimate fair value. This generally requires us to establish internal assumptions about future cash flows and appropriate risk-adjusted discount rates. Regardless of the valuation inputs we apply, the objective of fair value measurement is unchanged from what it would be if markets were operating at normal activity levels and/or transactions were orderly; that is, to determine the current exit price.

See *Note 5* for further discussion on fair value measurements.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2014
(Unaudited)

**Note 3. Summary of Significant Accounting Policies — (continued)**

***Fair Value Option***

We have the option to measure eligible financial assets, financial liabilities, and commitments at fair value on an instrument-by-instrument basis. This option is available when we first recognize a financial asset or financial liability or enter into a firm commitment. Subsequent changes in the fair value of assets, liabilities, and commitments where we have elected the fair value option are recorded in our consolidated statements of income.

We elect the fair value option for certain residential and commercial loans, Sequoia IO securities and mortgage servicing rights ("MSRs"). We generally elect the fair value option for residential and commercial loans that are held-for-sale, due to our intent to sell or securitize the loans in the near-term. We generally elect the fair value option for Sequoia IO securities as we use these in part to hedge certain risks associated with our residential loans held-for-sale. We elect the fair value option for our MSRs in order to reflect the current value of these investments in our financial position and results each period. We also elect the fair value option for certain secured borrowings we may recognize when the sale of commercial loans do not meet the sale criteria in ASC 860.

See *Note 5* for further discussion on the fair value option.

***Real Estate Loans***

*Residential and Commercial Loans — Held-for-Sale at Fair Value*

Residential and commercial loans held-for-sale include loans that we are marketing for sale to third parties, including transfers to securitization entities that we plan to sponsor and expect to be accounted for as sales for financial reporting purposes. We generally elect the fair value option for residential and commercial loans that we purchase with the intent to sell to third parties or transfer to Sequoia securitizations. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

*Residential and Commercial Loans — Held-for-Investment*

*Commercial Loans — Fair Value*

We may elect the fair value option for senior commercial mortgage loans that we originate or acquire that are bifurcated into a senior portion that is sold to a third party and a junior portion that we retain as an investment. When the transfer of the senior portion does not meet the criteria for sale treatment under GAAP, the entire loan (the senior and junior portions) remains on our consolidated balance sheet and we account for the transfer of the senior portion as a secured liability. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

*Residential and Commercial Loans — At Amortized Cost*

Loans held-for-investment include residential loans owned at consolidated Sequoia entities and commercial loans owned at the Commercial Securitization entity and by us, net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due or has been individually impaired, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have become greater than 90 days past due or individually impaired is reserved for in the allowance for loan losses. Residential loans delinquent more than 90 days or in foreclosure are characterized as a serious delinquency. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is accounted for as a reduction in the outstanding loan principal balance. When a seriously delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, loans that have been individually impaired may be placed back on accrual status if restructured and after the loan is considered reperforming. A restructured loan is considered reperforming when the loan has been current for at least 12 months.

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**Note 3. Summary of Significant Accounting Policies — (continued)**

We use the interest method to determine an effective yield to amortize the premium or discount on real estate loans held-for-investment. For residential loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine periodic amortization. For residential and commercial loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments, if any, to determine periodic amortization.

We reclassify loans held-for-investment as loans held-for-sale if we determine that these loans will be sold or transferred to third parties. This may occur, for example, if we exercise our right to call ABS issued by a Sequoia securitization trust and decide to subsequently sell the underlying loans to third parties.

See *Note 6* for further discussion on residential loans. See *Note 7* for further discussion on commercial loans.

*Residential Loans — Allowance for Loan Losses*

For residential loans classified as held-for-investment, we establish and maintain an allowance for loan losses based on our estimate of credit losses inherent in our loan portfolios at the reporting date. To calculate the allowance for loan losses, we assess inherent losses by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each loan or pool of loans.

We consider the following factors in evaluating the allowance for loan losses:

- Ongoing analyses of loans, including, but not limited to, the age of loans and year of origination, underwriting standards, business climate, economic conditions, and other observable data;
- Historical loss rates and past performance of similar loans;
- Relevant market research and publicly available third-party reference loss rates;
- Trends in delinquencies and charge-offs;
- Effects and changes in credit concentrations;
- Information supporting a borrower's ability to meet obligations;
- Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and,
- Discounted cash flow analyses.

Once we determine the amount of defaults, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each individual loan or pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an appropriate loss confirmation period. This period is defined as the range of time between the 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 estimated loss confirmation period are the basis of our allowance for loan losses, since we believe these losses exist at the reported date of the financial statements. We re-evaluate the adequacy of our allowance for loan losses quarterly.

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal amounts owed on a mortgage loan; and, (iv) extension of the contractual maturity of a mortgage loan. We evaluate all loan modifications performed by servicers to determine if they constitute troubled debt restructurings ("TDRs") according to GAAP. If a loan is determined to be a TDR, it is removed from the general loan pools used for calculating allowances for loan losses and assessed

**Note 3. Summary of Significant Accounting Policies — (continued)**

for impairment on an individual basis based upon any adverse change in the expected future cash flows resulting from the modification. This difference is recorded to the provision for loan losses in our consolidated statements of income.

When foreclosed property is received in full satisfaction for a defaulted loan, we estimate the fair value of the property, based on estimated net proceeds from the sale of the property (including servicer advances and other costs). To the extent that the fair value of the property is below the recorded investment of the loan, we record a charge against the allowance for loan losses for the difference. Foreclosed property is subsequently recorded as real estate owned ("REO"), a component of other assets on our consolidated balance sheets. Actual losses incurred on loans liquidated through a short-sale are also charged against the allowance for loan losses.

See *Note 6* for further discussion on the allowance for loan losses for residential loans.

*Commercial Loans — Allowance for Loan Losses*

For commercial loans classified as held-for-investment, we establish and maintain a general allowance for loan losses inherent in our portfolio at the reporting date and, where appropriate, a specific allowance for loan losses for loans we have determined to be impaired at the reporting date. An individual loan is considered impaired when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the loan.

Our methodology for assessing the adequacy of the allowance for loan losses begins with a formal review of each commercial loan in the portfolio and the assignment of an internal impairment status. Reviews are performed at least quarterly. We consider the following factors in evaluating each loan:

- Loan to value ratios upon origination or acquisition of the loan;
- The most recent financial information available for each loan and associated properties, including net operating income, debt service coverage ratios, occupancy rates, rent rolls, as well as any other loss factors we consider relevant, such as, but not limited to, specific loan trigger events that would indicate an adverse change in expected cash flows or payment delinquency;
- Economic trends, both macroeconomic as well as those directly affecting the properties associated with our loans, and the supply and demand of competing projects in the sub-market in which the subject property is located; and,
- The loan sponsor or borrowing entity's ability to ensure that properties associated with the loan are managed and operated sufficiently.

Loan reviews are completed by asset management and finance personnel and reviewed and approved by senior management.

Based on the assigned internal impairment status, a loan is categorized as "Pass," "Watch List," or "Workout." Pass loans are defined as loans that are performing in accordance with the contractual terms of the loan agreement. Watch List loans are defined as performing loans for which the timing of cost recovery is under review. Workout loans are defined as loans that we believe have a credit impairment that may lead to a realized loss. Workout loans are typically assessed for impairment on an individual basis. Where an individual commercial loan is impaired, we record an allowance to reduce the carrying value of the loan to the current present value of expected future cash flows discounted at the loan's effective rate or if a loan is collateral dependent, we reduce the carrying value to the estimated fair market value of the loan, with a corresponding charge to provision for loan losses on our consolidated statements of income.

For all commercial loans that are not individually impaired, we assess the commercial loan portfolio in aggregate for loan losses based on our expectation of credit losses inherent in the portfolio at the reporting date. Our expectation of credit losses is informed by, among other things:

- Historical loss rates and past performance of similar loans in our own portfolio, if any;
- Publicly available third-party reference loss rates on similar loans; and,
- Trends in delinquencies and charge-offs in our own portfolio and among industry participants.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 3. Summary of Significant Accounting Policies — (continued)**

See *Note 7* for further discussion on the allowance for loan losses for commercial loans.

*Repurchase Reserves*

We sell residential mortgage loans to various parties, including (1) securitization trusts, (2) Fannie Mae and Freddie Mac (the “Agencies”), and (3) banks and other financial institutions that purchase mortgage loans. We also purchase mortgage servicing rights. We may be required to repurchase residential mortgage loans in the event of a breach of specified contractual representations and warranties made in connection with these sales and purchases. We do not originate residential mortgage loans and believe the initial risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans. However, in some cases, such as where loans were acquired from companies that have since become insolvent, we may be required to repurchase loans.

We establish reserves for mortgage repurchase liabilities related to various representations and warranties that reflect management’s estimate of losses for loans for which we could have a repurchase obligation, based on a combination of factors. Such factors can include estimated future defaults and loan repurchase rates, the potential severity of loss in the event of defaults, and the probability of our being liable for a repurchase obligation. We establish a reserve at the time loans are sold and continually update our reserve estimate during its life. The reserve for mortgage loan repurchase losses is included in other liabilities on our consolidated balance sheets and the related expense is included as a component of mortgage banking activities, net on our consolidated statements of income.

See *Note 15* for further discussion on the residential repurchase reserves.

We have originated and sold commercial mortgage loans and have made standard representations and warranties upon sale of the loans to the loan purchasers, and in some cases, to securitization trusts. We review the need for a repurchase reserve related to these commercial loans on an ongoing basis and are not aware of any breaches of representations and warranties related to these loans.

***Real Estate Securities, at Fair Value***

We classify our real estate securities as trading or available-for-sale securities. We use the “prime” or “non-prime” designation to categorize our residential securities based upon the general credit characteristics of the residential loans underlying each security at the time of origination. For example, prime residential loans are generally characterized by lower loan-to-value (“LTV”) ratios at the time the loans were originated, and are made to borrowers with higher Fair Isaac Corporation (“FICO”) scores. Non-prime residential loans are generally characterized by higher LTV ratios at the time the loans were originated and may have been made to borrowers with lower credit scores or impaired credit histories (while exhibiting the ability to repay their loans) at the time the loan was originated. Regardless of whether or not the loans underlying a residential security were designated as prime or non-prime at origination, there is a risk that the borrower may not be able to repay the loan.

*Trading Securities*

We primarily denote trading securities as those securities where we have adopted the fair value option. Trading securities are carried at their estimated fair values and coupon interest is recognized as interest income when earned and deemed collectible. Changes in the fair value of Sequoia IO and senior securities designated as trading securities are reported in mortgage banking activities, net, a component of our consolidated statements of income. Changes in the fair value of other trading securities are reported through our consolidated statements of income in other market valuation adjustments, net.

*Available-for-Sale Securities*

AFS securities primarily consist of non-agency residential mortgage backed securities (“RMBS”) and may include other residential and commercial securities. Non-agency RMBS are not issued or guaranteed by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or any agency of the U.S. Government. AFS securities are carried at their estimated fair value with unrealized gains and losses excluded from earnings (except when an other-than-temporary impairment (“OTTI”) is recognized, as discussed below) and reported in accumulated other comprehensive income (“AOCI”), a component of stockholders’ equity.

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**Note 3. Summary of Significant Accounting Policies — (continued)**

Interest income on AFS securities is accrued based on their outstanding principal balance and contractual terms and interest income is recognized based on the security's effective interest rate. In order to calculate the effective interest rate, we must project cash flows over the remaining life of each security and make assumptions with regards to interest rates, prepayment rates, the timing and amount of credit losses, and other factors. On at least a quarterly basis, we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our own judgments about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on these securities or in the recognition of OTTI as discussed below.

For AFS securities purchased and held at a discount, a portion of the discount may be designated as non-accretable purchase discount ("credit reserve"), based on the cash flows we have projected for the security. The amount designated as credit reserve may be adjusted over time, based on our periodic evaluation of projected cash flows. If the performance of a security with a credit reserve is more favorable than previously forecasted, a portion of the credit reserve may be reallocated to accretable discount and recognized into interest income over time. Conversely, if the performance of a security with a credit reserve is less favorable than forecasted, the amount designated as credit reserve may be increased, or impairment charges and write-downs of such securities to a new cost basis could result.

When the fair value of an AFS security is less than its amortized cost at the reporting date, the security is considered impaired. We assess our impaired securities at least quarterly to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). If we either — (i) intend to sell the impaired security; (ii) will more likely than not be required to sell the impaired security before it recovers in value; or (iii) if there has been an adverse change in cash flows — the impairment is deemed an OTTI. In the case of criteria (i) and (ii), we record the entire difference between the security's estimated fair value and its amortized cost at the reporting date in our consolidated statements of income. If there has been an adverse change in cash flows, only the portion of the OTTI related to "credit" losses is recognized through other market valuation adjustments, net on our consolidated statements of income, with the remaining "non-credit" portion recognized through AOCI on our consolidated balance sheet. If the first two criteria are not met and there has not been an adverse change in cash flows, the impairment is considered temporary and the entire unrealized loss is recognized through AOCI on our consolidated balance sheets.

For impaired AFS securities, to determine if there has been an adverse change in cash flows and if any portion of a resulting OTTI is related to credit losses, we compare the present value of the cash flows expected to be collected as of the current financial reporting date to the amortized cost basis of the security. The discount rate used to calculate the present value of expected future cash flows is the current yield used for income recognition purposes. If the present value of the current expected cash flows is less than the amortized cost basis, there has been an adverse change and the security is considered OTTI with the difference between these two amounts representing the credit loss. The determination as to whether an OTTI exists and, if so, the amount of credit impairment recognized in earnings is subjective, and based on information available at the time of the assessment as well as our estimates of future performance and cash flows. As a result, the timing and amount of OTTI constitute a material estimate that is susceptible to significant change.

See *Note 8* for further discussion on real estate securities.

***MSRs***

We recognize MSRs through the retention of servicing rights associated with residential mortgage loans that we have acquired and subsequently transferred to third parties (including the Agencies) or through the direct acquisition of MSRs sold by third parties. Typically, our MSRs are created through the transfer of loans to a third party or to a Sequoia residential mortgage securitization sponsored by us that meets the GAAP criteria for sale accounting.

Our MSRs are held and managed at Redwood Residential Acquisition Corporation, a wholly-owned subsidiary of RWT Holdings, Inc., which is a taxable REIT subsidiary of ours. We contract with a licensed sub-servicer to perform servicing functions for loans associated with our MSRs. We have elected the fair value option for all of our MSRs, and they are initially recognized and carried at their estimated fair values. Income from MSRs and changes in the estimated fair value of MSRs are reported in MSR income, net, a component of our consolidated statements of income.

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**Note 3. Summary of Significant Accounting Policies — (continued)**

See *Note 9* for further discussion on MSRs.

### *Cash and Cash Equivalents*

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less.

### *Restricted Cash*

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities. Restricted cash may also include cash retained in the Sequoia securitization entities or in the Residential Resecuritization or Commercial Securitization entities prior to the payments on or redemptions of outstanding ABS issued.

### *Accrued Interest Receivable*

Accrued interest receivable includes interest that is due and payable to us and deemed collectible. Cash interest is generally received within thirty days of recording the receivable. For financial assets where we have elected the fair value option, the associated accrued interest receivable on these assets is measured at fair value. For financial assets where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

### *Derivative Financial Instruments*

Derivative financial instruments we typically utilize include swaps, swaptions, financial futures contracts, CMBX credit default index swaps, and “To Be Announced” (“TBA”) contracts. These derivatives are primarily used to manage interest rate risk associated with our operations. In addition, we enter into certain residential loan purchase commitments (“LPCs”) and residential loan forward sale commitments (“FSCs”) that are treated as derivatives for financial reporting purposes. All derivative financial instruments are recorded at their estimated fair values on our consolidated balance sheets. Derivatives with positive fair values to us are reported as assets and derivatives with negative fair values to us are reported as liabilities. We classify each derivative as either (i) a trading instrument (no specific hedging designation for financial reporting purposes) or (ii) 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).

Changes in the fair values of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income through other market valuation adjustments, net, to the extent they are used to manage risks associated with our residential investment portfolio. Derivatives used to manage certain risks associated with our residential and commercial mortgage banking activities, including valuation changes related to residential LPCs and FSCs, are included in mortgage banking activities, net, on our consolidated statements of income.

Changes in the fair values of derivatives accounted for as cash flow hedges, to the extent they are effective, are recorded in accumulated other comprehensive income, a component of equity on our consolidated balance sheets. Interest income or expense, and any ineffectiveness associated with these derivatives, are recorded as a component of net interest income in our consolidated statements of income. We measure the effective portion of cash flow hedges by comparing the change in fair value of the expected future variable cash flows of the derivative hedging instruments with the change in fair value of the expected future variable cash flows of the hedged item.

We will discontinue a designated cash flow hedging relationship if (i) we determine that the hedging derivative is no longer expected to be effective in offsetting changes in the cash flows of the designated hedged item; (ii) the derivative expires or is sold, terminated, or exercised; (iii) the derivative is de-designated as a cash flow hedge; or, (iv) it is probable that a forecasted transaction associated with the hedged item will not occur by the end of the originally specified time period. To the extent we de-designate or terminate a cash flow hedging relationship and the associated hedged item continues to exist, any unrealized gain or loss of the cash flow hedge at the time of de-designation remains in accumulated other comprehensive income and is amortized using the straight-line method through interest expense over the remaining life of the hedged item.

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**Note 3. Summary of Significant Accounting Policies — (continued)**

*Swaps and Swaptions*

Interest rate swaps are agreements in which (i) one counterparty exchanges a stream of fixed interest payments for another counterparty's stream of variable interest cash flows; or, (ii) each counterparty exchanges variable interest cash flows that are referenced to different indices. Interest rate swaptions are agreements that provide the owner the right but not the obligation to enter into an underlying interest rate swap with a counterparty in the future. Interest rate caps are agreements in which the owner receives payments at the end of each period for which the prevailing interest rate exceeds an agreed upon strike price. We enter into interest rate agreements primarily to reduce significant changes in our income or equity caused by interest rate volatility. Certain of these interest rate agreements may be designated as cash flow hedges.

*Eurodollar Futures and Financial Futures*

Eurodollar futures are futures contracts on time deposits denominated in U.S. dollars at banks outside the United States. Eurodollar futures, unlike our other derivatives, have maturities of only three months. Therefore, in order to achieve the desired interest rate offset necessary to manage our risk, consecutively maturing contracts are required, resulting in a stated notional amount that is typically higher than our other derivatives. Financial futures are futures contracts on benchmark U.S. Treasury rates.

*TBA Contracts*

TBA contracts are forward contracts to purchase mortgage-backed securities that will be issued by a U.S. government sponsored enterprise in the future. We purchase or sell these derivatives to offset — to varying degrees — changes in the values of mortgage products for which we have exposure to interest rate volatility.

*Credit Default Index Swaps*

Credit default index swaps include instruments such as CMBX, which are indexes referencing tranches from 25 different commercial mortgage-backed securities ("CMBS") deals, each with different credit ratings. The CMBX indexes enable participants to hedge or gain exposure to a series of similar CMBS securities. We utilize CMBX to hedge certain risks related to senior commercial mortgage loans we originate for sale into CMBS.

*Loan Purchase and Forward Sale Commitments*

We use the term LPCs to refer to agreements with third-party residential loan originators to purchase residential loans at a future date that qualify as a derivative under GAAP. LPCs are recorded at their estimated fair values on our consolidated balance sheets. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net. We use the term FSCs to refer to agreements with third-parties to sell residential loans at a future date that also qualify as derivatives under GAAP. FSCs are recorded at their estimated fair values on our consolidated balance sheets. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

See *Note 10* for further discussion on derivative financial instruments.

***Deferred Tax Assets and Liabilities***

Our deferred tax assets/liabilities are generated by temporary differences in GAAP and taxable income at our taxable subsidiaries. These differences generally reflect differing accounting treatments for GAAP and tax, such as accounting for mortgage servicing rights, discount and premium amortization, credit losses, asset impairments, and certain valuation estimates. As a result of these differences, we may recognize taxable income in periods prior to when we recognize income for GAAP. When this occurs, we pay the tax liability as required and establish a deferred tax asset. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is reduced. We may also recognize income under GAAP in periods prior to when we recognize the income for tax. When this occurs, we establish a deferred tax liability. As the income is subsequently realized in future periods for tax, the deferred tax liability is reduced.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 3. Summary of Significant Accounting Policies — (continued)**

taxable income during the periods in which those temporary differences become deductible. We consider historical and projected future taxable income and capital gains as well as tax planning strategies in making this assessment. We determine the extent to which realization of this deferred asset is not assured and establish a valuation allowance accordingly. The estimate of net deferred tax assets could change in future periods to the extent that actual or revised estimates of future taxable income during the carryforward periods change from current expectations.

***Deferred Securities Issuance Costs***

Securities issuance costs are expenses associated with the issuance of long-term debt, and the ABS issued from the Residential Resecuritization, the Commercial Securitization, and Sequoia securitization entities we sponsor and consolidate for financial reporting purposes. These expenses typically include underwriting, rating agency, legal, accounting, and other fees. ABS issuance costs associated with liabilities reported at cost are deferred. Deferred securities issuance costs are reported on our consolidated balance sheets as deferred charges (an asset) and are amortized as an adjustment to interest expense using the interest method, based upon the actual and estimated repayment schedules of the related securities issued.

***Other Assets***

Other assets include margin and investment receivable, REO, income tax receivables, fixed assets, principal receivable, and other prepaid expenses and receivables.

REO property acquired through, or in lieu of, foreclosure is initially recorded at fair value, and subsequently reported at the lower of its carrying amount or fair value (less estimated cost to sell). Changes in the fair value of an REO property that has a fair value at or below its carrying amount are recorded in our consolidated statements of income as a component of other market valuation adjustments, net. Margin receivable reflects cash collateral we have posted with various counterparties relating to our derivative and lending agreements with those counterparties, as applicable.

See *Note 11* for further discussion on other assets.

***Short-Term Debt***

Short-term debt includes borrowings under master repurchase agreements, loan warehouse facilities, and other forms of borrowings that expire within one year with various counterparties. These borrowings may be unsecured or collateralized by cash, loans, or securities. If the value (as determined by the applicable counterparty) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the counterparty may retain the collateral and pursue any outstanding debt amount from us.

See *Note 12* for further discussion on short-term debt.

***Accrued Interest Payable***

Accrued interest payable includes interest that is due and payable to third parties. Interest is generally paid within one to three months of recording the payable, based upon our remittance requirements, and is paid semi-annually for our convertible debt. For borrowings where we have elected the fair value option, the associated accrued interest on these liabilities is measured at fair value. For financial liabilities where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

***Asset-Backed Securities Issued***

ABS issued represents asset-backed securities issued by bankruptcy-remote entities sponsored and consolidated by Redwood. These entities include certain Sequoia entities, the Residential Resecuritization, and the Commercial Securitization. Assets at these entities are held in the custody of securitization trustees and are not owned by Redwood. These trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the ABS investors.

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**Note 3. Summary of Significant Accounting Policies — (continued)**

ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium.

See *Note 13* for further discussion on ABS issued.

***Long-Term Debt***

*Commercial Long-term Debt*

Commercial long-term debt includes borrowings under a master repurchase agreement that expires in more than one year with a financial institution counterparty. These borrowings are collateralized by commercial loans. If the value (as determined by the applicable counterparty) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the counterparty may retain the collateral and pursue any outstanding debt amount from us.

*Commercial Secured Borrowings*

Commercial secured borrowings represent liabilities recognized in association with cash received from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under ASC 860 and were accounted for as financings. We elect the fair value option for these secured borrowings and they are held at their estimated fair value on our consolidated balance sheets.

*Convertible Notes*

Convertible notes include unsecured convertible senior notes and are carried at their unpaid principal balance. Interest on the notes is payable semiannually and the notes mature on April 15, 2018. If converted by a holder, upon conversion the holder of the notes would receive shares of our common stock.

*Trust Preferred Securities and Subordinated Notes*

Trust preferred securities and subordinated notes are carried at their unpaid principal balance. This long-term debt is unsecured with quarterly interest payments determined based upon a floating rate equal to the three-month London Interbank Offered Rate (“LIBOR”) plus a margin until it is redeemed in whole or matures at a future date.

See *Note 14* for further discussion on long-term debt.

***Equity***

*Accumulated Other Comprehensive Income*

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements designated as cash flow hedges are reported as components of accumulated other comprehensive income on our consolidated statements of changes in equity and our consolidated balance sheets. Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive income are adjusted for the effects of taxation and may create deferred tax assets or liabilities.

*Earnings Per Common Share*

Basic earnings per common share (“EPS”) is computed by dividing net income allocated to common shareholders by the weighted average common shares outstanding. Net income allocated to common shareholders represents net income allocable to common shareholders, less income allocated to participating securities (as described herein). Diluted EPS is computed by dividing income allocated to common shareholders by the weighted average common shares outstanding plus amounts representing the dilutive effect of share-based payment awards. In addition, if the assumed conversion of convertible notes to common shares is dilutive, diluted EPS is adjusted by adding back the periodic interest expense associated with dilutive convertible debt to net income and adding the shares issued in an assumed conversion to the diluted share count.

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**Note 3. Summary of Significant Accounting Policies — (continued)**

The two-class method is an earnings allocation formula under which EPS is calculated for common stock and participating securities according to dividends declared and participating rights in undistributed earnings. Under this method, all earnings (distributed and undistributed) are allocated between participating securities and common shares based on their respective rights to receive dividends or dividend equivalents. Accounting guidance on EPS defines vested and unvested share-based payment awards containing nonforfeitable rights to dividends or dividend equivalents as participating securities that are included in computing EPS under the two-class method.

See *Note 16* for further discussion on equity.

***Incentive Plans***

In May 2014, our shareholders approved the 2014 Redwood Trust, Inc. Incentive Plan ("Incentive Plan") for executive officers, employees, and non-employee directors, which replaced the 2002 Redwood Trust, Inc. Incentive Plan. The Incentive Plan provides for the grant of restricted stock, deferred stock, deferred stock units, performance-based awards (including performance stock units), dividend equivalents, stock payments, restricted stock units, and other types of awards to eligible participants. Long-term incentive awards granted under the Incentive Plan generally vest over a three- or four-year period. Awards made under the Incentive Plan to officers and other employees in lieu of the payment in cash of a portion of annual bonuses earned generally vest immediately, but are subject to a three-year mandatory holding period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately. The cost of the awards is amortized over the vesting period on a straight-line basis.

*Employee Stock Purchase Plan*

In May 2013, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Employee Stock Purchase Plan ("ESPP") to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in the Company through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the last day of the calendar quarter.

*Executive Deferred Compensation Plan*

In November 2013, our Board of Directors approved an amendment to our 2002 Executive Deferred Compensation Plan ("EDCP") to allow non-employee directors to defer certain cash payments and dividends into Deferred Stock Units ("DSUs"). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. The Company matches some deferrals. Compensation deferred under the EDCP is recorded as a liability on our consolidated balance sheets. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs.

*401(k) Plan*

We offer a tax-qualified 401(k) Plan to all employees for retirement savings. Under this Plan, employees are allowed to defer and invest up to 100% of their cash earnings, subject to the maximum 401(k) Plan contribution limit set forth by the Internal Revenue Service. We match some employee contributions to encourage participation and to provide a retirement planning benefit to employees. Vesting of the 401(k) Plan matching contributions is based on the employee's tenure at the Company, and over time an employee becomes increasingly vested in both prior and new matching contributions.

See *Note 17* for further discussion on equity compensation plans.

***Taxes***

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. To qualify as a REIT we must distribute at least 90% of our annual REIT taxable income to shareholders (not including taxable income retained in our taxable subsidiaries) within the time frame set forth in the tax code and also meet certain other requirements related to assets, income, and stock ownership. We assess our tax positions for all open tax years and record tax benefits only if tax positions meet a

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 3. Summary of Significant Accounting Policies — (continued)**

more-likely-than-not threshold in accordance with FASB guidance on accounting for uncertainty in income taxes. We classify interest and penalties on material uncertain tax positions as interest expense and operating expense, respectively, in our consolidated statements of income.

See *Note 20* for further discussion on taxes.

***Recent Accounting Pronouncements***

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers." ASU 2014-09 supersedes the revenue recognition requirements in "Topic 605, Revenue Recognition" and requires entities to recognize revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective retrospectively for annual or interim reporting periods beginning after December 15, 2016, with early application not permitted. We are currently evaluating the new standard.

***Balance Sheet Netting***

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

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at June 30, 2014 and December 31, 2013.

***Offsetting of Financial Assets, Liabilities, and Collateral***

| June 30, 2014 (In Thousands) | Gross Amounts of Recognized Assets (Liabilities) | Gross Amounts Offset in Consolidated Balance Sheet | Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet | Gross Amounts Not Offset in Consolidated Balance Sheet [1] | | Net Amount |
|---|---|---|---|---|---|---|
| | | | | Financial Instruments | Cash Collateral (Received) Pledged | |
| **Assets [2]** | | | | | | |
| Interest rate agreements | $ 1,925 | $ - | $ 1,925 | $ (572) | $ - | $ 1,353 |
| Credit default index swaps | 588 | - | 588 | - | - | 588 |
| TBAs | 3,294 | - | 3,294 | (2,499) | - | 795 |
| **Total Assets** | $ 5,807 | $ - | $ 5,807 | $ (3,071) | $ - | $ 2,736 |
| **Liabilities [2]** | | | | | | |
| Interest rate agreements | $ (32,637) | $ - | $ (32,637) | $ 572 | $ 32,065 | $ - |
| TBAs | (5,540) | - | (5,540) | 2,499 | 1,746 | (1,295) |
| Futures | (494) | - | (494) | - | 494 | - |
| Loan warehouse debt | (864,680) | - | (864,680) | 864,680 | - | - |
| Security repurchase agreements | (853,750) | - | (853,750) | 853,750 | - | - |
| Commercial borrowings | (52,916) | - | (52,916) | 52,916 | - | - |
| **Total Liabilities** | $ (1,810,017) | $ - | $ (1,810,017) | $ 1,774,417 | $ 34,305 | $ (1,295) |

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 3. Summary of Significant Accounting Policies — (continued)**

| December 31, 2013 (In Thousands) | Gross Amounts of Recognized Assets (Liabilities) | Gross Amounts Offset in Consolidated Balance Sheet | Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet | Gross Amounts Not Offset in Consolidated Balance Sheet (1) | | Net Amount |
|---|---|---|---|---|---|---|
| | | | | Financial Instruments | Cash Collateral (Received) Pledged | |
| **Assets (2)** | | | | | | |
| Interest rate agreements | $ 6,566 | $ - | $ 6,566 | $ (5,402) | $ - | $ 1,164 |
| TBAs | 1,138 | - | 1,138 | (656) | (482) | - |
| Futures | - | - | - | - | - | - |
| **Total Assets** | $ 7,704 | $ - | $ 7,704 | $ (6,058) | $ (482) | $ 1,164 |
| **Liabilities (2)** | | | | | | |
| Interest rate agreements | $ (16,599) | $ - | $ (16,599) | $ 5,402 | $ 11,197 | $ - |
| TBAs | (661) | - | (661) | 656 | 5 | - |
| Futures | (528) | - | (528) | - | 528 | - |
| Loan warehouse debt | (184,789) | - | (184,789) | 184,789 | - | - |
| Security repurchase agreements | (677,974) | - | (677,974) | 677,974 | - | - |
| Commercial borrowings | (49,467) | - | (49,467) | 49,467 | - | - |
| **Total Liabilities** | $ (930,018) | $ - | $ (930,018) | $ 918,288 | $ 11,730 | $ - |

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

(2) Interest rate agreements, TBAs, and futures are components of derivatives instruments on our consolidated balances sheets. Loan warehouse debt, which is secured by residential and commercial mortgage loans, and security repurchase agreements are components of short-term debt on our consolidated balance sheets. Commercial borrowings are a component of long-term debt on our consolidated balance sheets.

For each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions within that category between Redwood and a counterparty are subject to a master netting arrangement or similar agreement with that counterparty that provides for individual transactions to be treated as a single transaction. For certain categories of these instruments, some of our transactions are cleared and settled through one or more clearinghouses that are substituted as our counterparty and references herein to master netting arrangements or similar agreements include the arrangements and agreements governing the clearing and settlement of these transactions through the clearinghouses. In the event of the termination and close-out of any of those transactions, the corresponding master netting arrangement or similar agreement provides for settlement on a net basis and for settlement to include the proceeds of the liquidation of any corresponding collateral, subject to certain limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party that should not inhibit the eventual practical realization of the principal benefits of those transactions or the corresponding master netting arrangement or similar agreement and any corresponding collateral.

**Note 4. Principles of Consolidation**

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**Note 4. Principles of Consolidation — (continued)**

***Analysis of Consolidated VIEs***

The VIEs we are required to consolidate include certain Sequoia securitization entities, the Residential Resecuritization entity, and the Commercial Securitization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of ours, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities as well as from retained financial interests we hold in certain of these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

***Assets and Liabilities of Consolidated VIEs at June 30, 2014***

| June 30, 2014 (Dollars in Thousands) | Sequoia Entities | Residential Resecuritization | Commercial Securitization | Total |
|---|---|---|---|---|
| Residential loans, held-for-investment | $ 1,616,504 | $ - | $ - | $ 1,616,504 |
| Commercial loans, held-for-investment | - | - | 254,615 | 254,615 |
| Real estate securities, at fair value | - | 245,853 | - | 245,853 |
| Restricted cash | 145 | - | 138 | 283 |
| Accrued interest receivable | 2,391 | 549 | 1,826 | 4,766 |
| Other assets | 3,323 | - | 79 | 3,402 |
| **Total Assets** | $ 1,622,363 | $ 246,402 | $ 256,658 | $ 2,125,423 |
| Accrued interest payable | $ 1,078 | $ 17 | $ 678 | $ 1,773 |
| Asset-backed securities issued | 1,553,669 | 69,709 | 144,700 | 1,768,078 |
| **Total Liabilities** | $ 1,554,747 | $ 69,726 | $ 145,378 | $ 1,769,851 |
| **Number of VIEs** | 24 | 1 | 1 | 26 |

We consolidate the assets and liabilities of certain Sequoia securitization entities, as we did not meet the GAAP sale criteria at the time we transferred financial assets to these entities. Our involvement in consolidated Sequoia entities continues in the following ways: (i) we continue to hold subordinate investments in each entity, and for certain entities, more senior investments; (ii) we maintain certain discretionary rights associated with our sponsorship of, or our subordinate investments in, each entity; and (iii) we continue to hold a right to call the assets of certain entities (once they have been paid down below a specified threshold) at a price equal to, or in excess of, the current outstanding principal amount of the entity's asset-backed securities issued. These factors have resulted in our continuing to consolidate the assets and liabilities of these Sequoia entities in accordance with GAAP.

We consolidate the assets and liabilities of the Residential Resecuritization entity as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity's inception and design. We transferred senior residential securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold them to CSMC 2011-9R, the Residential Resecuritization entity. In connection with this transaction, we acquired certain senior and subordinate securities that we continue to hold. We engaged in the Residential Resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our senior residential securities portfolio. Our credit risk exposure is largely unchanged as a result of engaging in the transaction, as we remain economically exposed to the financed securities through our senior and subordinate investment in the Residential Resecuritization.

We consolidate the assets and liabilities of the Commercial Securitization entity, as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity's inception and design. We transferred subordinate commercial loans to RCMC 2012-CREL1, a securitization entity. In connection with this transaction, we acquired certain subordinate securities that we continue to hold. We engaged in the Commercial Securitization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our commercial mezzanine loan portfolio. Our credit risk exposure is largely unchanged as a result of engaging in the transaction, as we remain economically exposed to the financed loans through our subordinate investment in the Commercial Securitization.

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**Note 4. Principles of Consolidation — (continued)**

***Analysis of Unconsolidated VIEs with Continuing Involvement***

Since 2012, we have transferred residential loans to 19 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSRs on our consolidated balance sheets, and classified those MSRs as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets.

The following table presents information related to securitization transactions that occurred during the three and six months ended June 30, 2014 and 2013.

***Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Principal balance of loans transferred | $ 347,305 | $ 1,802,058 | $ 347,305 | $ 4,042,710 |
| Trading securities retained, at fair value | 69,563 | 40,642 | 69,563 | 91,850 |
| AFS securities retained, at fair value | 20,428 | 92,367 | 20,428 | 207,095 |
| Gains on sale | - | - | - | - |
| MSRs recognized | 2,186 | 16,148 | 2,186 | 28,614 |

Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSRs (which we retain a third-party servicer to perform) and the receipt of interest income associated with the securities we retained. The following table summarizes the cash flows between us and the unconsolidated VIEs sponsored by us during the three and six months ended June 30, 2014 and 2013.

***Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Cash proceeds | $ 267,776 | $ 1,705,504 | $ 267,776 | $ 3,859,354 |
| MSR fees received | 3,624 | 2,099 | 7,047 | 3,075 |
| Funding of compensating interest | (43) | (145) | (76) | (263) |
| Cash flows received on retained securities | 15,924 | 9,883 | 28,227 | 14,950 |

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

***MSR Assumptions Related to Unconsolidated VIEs Sponsored by Redwood***

| | Issued During | | | |
|---|---|---|---|---|
| | Three Months Ended June 30, | | Six Months Ended June 30, | |
| **At Date of Securitization** | **2014** | **2013** | **2014** | **2013** |
| Prepayment speeds | 5 - 15 % | 5 - 12 % | 5 - 15 % | 5 - 14 % |
| Discount rates | 11 % | 12 % | 11 % | 12 % |

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**Note 4. Principles of Consolidation — (continued)**

The following table presents additional information at June 30, 2014 and December 31, 2013, related to unconsolidated securitizations accounted for as sales since 2012. Loans at these securitization entities have not incurred any credit losses.

*Unconsolidated VIEs Sponsored by Redwood*

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| On-balance sheet assets, at fair value: | | |
| Interest-only and senior securities, classified as trading | $ 159,311 | $ 110,505 |
| Senior and subordinate securities, classified as AFS | 449,863 | 405,415 |
| Maximum loss exposure (1) | 609,174 | 515,920 |
| Assets transferred: | | |
| Principal balance of loans outstanding | 6,730,820 | 6,627,874 |
| Principal balance of delinquent loans 30+ days delinquent | 7,041 | 14,587 |

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

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at June 30, 2014 and December 31, 2013.

***Key Assumptions and Sensitivity Analysis for Assets Retained from Unconsolidated VIEs Sponsored by Redwood***

| June 30, 2014<br>(Dollars in Thousands) | MSRs | Senior Securities | Subordinate Securities |
|---|---|---|---|
| Fair value at June 30, 2014 | $ 54,712 | $ 159,311 | $ 449,863 |
| Expected life (in years) (1) | 7 | 7 | 11 |
| Prepayment speed assumption (annual CPR) (1) | 12 % | 9 % | 10 % |
| Decrease in fair value from: | | | |
| 10% adverse change | $ 2,088 | $ 7,254 | $ 1,345 |
| 25% adverse change | 4,908 | 12,104 | 3,519 |
| Discount rate assumption (1) | 11 % | 5 % | 6 % |
| Decrease in fair value from: | | | |
| 100 basis point increase | $ 2,194 | $ 7,929 | $ 34,532 |
| 200 basis point increase | 4,212 | 15,159 | 65,057 |
| Credit loss assumption (1) | N/A | 0.23 % | 0.23 % |
| Decrease in fair value from: | | | |
| 10% higher losses | N/A | $ 89 | $ 1,197 |
| 25% higher losses | N/A | 222 | 2,380 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 4. Principles of Consolidation — (continued)**

| December 31, 2013 (Dollars in Thousands) | MSRs | Senior Interest-only Securities | Subordinate Securities |
|---|---|---|---|
| Fair value at December 31, 2013 | $ 60,318 | $ 110,505 | $ 405,415 |
| Expected life (in years) (1) | 8 | 7 | 11 |
| | | | |
| Prepayment speed assumption (annual CPR) (1) | 8 % | 10 % | 11 % |
| Decrease in fair value from: | | | |
| 10% adverse change | $ 1,649 | $ 5,773 | $ 1,658 |
| 25% adverse change | 4,218 | 13,555 | 4,354 |
| | | | |
| Discount rate assumption (1) | 11 % | 5 % | 6 % |
| Decrease in fair value from: | | | |
| 100 basis point increase | $ 2,468 | $ 5,632 | $ 30,644 |
| 200 basis point increase | 4,828 | 10,757 | 57,836 |
| | | | |
| Credit loss assumption (1) | N/A | 0.23 % | 0.23 % |
| Decrease in fair value from: | | | |
| 10% higher losses | N/A | $ 70 | $ 1,369 |
| 25% higher losses | N/A | 175 | 3,420 |

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

***Continuing Involvement with VIEs with No Economic Interest***

We maintain limited continuing involvement in certain Acacia securitization entities we sponsored, but have no current economic interest in these entities. Our continuing involvement as collateral manager has, under the terms of the applicable management agreements, been significantly curtailed or eliminated with respect to the Acacia entities, as all but one of these entities have experienced events of default. We will continue to receive the collateral management fees for these entities, which have decreased significantly and will continue to do so as the balances on which the fees are determined continue to decline.

***Analysis of Third-Party VIEs***

Third-party VIEs are securitization entities for which we maintain an economic interest but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at June 30, 2014, grouped by collateral type.

***Third-Party Sponsored VIE Summary***

| (In Thousands) | June 30, 2014 |
|---|---|
| Residential real estate securities at Redwood | |
| Senior | $ 663,587 |
| Re-REMIC | 192,596 |
| Subordinate | 133,857 |
| **Total Investments in Third-Party Real Estate Securities** | $ 990,040 |

We determined that we are not the primary beneficiary of any third-party residential, commercial, or collateralized debt obligation entities, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise hold decision making powers that are significant. As a

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**Note 4. Principles of Consolidation — (continued)**

result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs – we only account for our specific interests in them.

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

***Other Transfers of Financial Assets***

Certain of our senior commercial mortgage loans were bifurcated into a senior portion that was sold to a third party and a junior portion that we retained as an investment. When the transfer of the senior portion did not meet the criteria for sale treatment under GAAP, the entire loan (the senior and junior portions) remains on our consolidated balance sheet classified as a held-for-investment loan and we account for the transfer of the senior portion as a secured borrowing.

The following table presents commercial loan transfers accounted for as secured borrowings for the three and six months ended June 30, 2014.

***Loan Transfers Accounted for as Secured Borrowings***

| (In Thousands) | Three Months Ended June 30, 2014 | Six Months Ended June 30, 2014 |
|---|---|---|
| Principal balance | $ 29,500 | $ 63,375 |
| Cash proceeds | 30,274 | 65,048 |

**Note 5. Fair Value of Financial Instruments**

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

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

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**Note 5. Fair Value of Financial Instruments — (continued)**

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at June 30, 2014 and December 31, 2013.

| | June 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| (In Thousands) | Carrying Value | Fair Value | Carrying Value | Fair Value |
| **Assets** | | | | |
| Residential loans, held-for-sale | | | | |
| At fair value | $ 1,106,239 | $ 1,106,239 | $ 402,602 | $ 402,602 |
| At lower of cost or fair value | 1,638 | 1,788 | 1,665 | 1,817 |
| Residential loans, held-for-investment | 1,616,504 | 1,508,571 | 1,762,167 | 1,610,024 |
| Commercial loans, held-for-sale | 50,848 | 50,848 | 89,111 | 89,111 |
| Commercial loans, held-for-investment | | | | |
| At fair value | 71,270 | 71,270 | - | - |
| At amortized cost | 346,648 | 353,004 | 343,344 | 348,305 |
| Trading securities | 173,281 | 173,281 | 124,555 | 124,555 |
| Available-for-sale securities | 1,671,786 | 1,671,786 | 1,558,306 | 1,558,306 |
| MSRs | 71,225 | 71,225 | 64,824 | 64,824 |
| Cash and cash equivalents | 157,079 | 157,079 | 173,201 | 173,201 |
| Restricted cash | 393 | 393 | 398 | 398 |
| Accrued interest receivable | 15,109 | 15,109 | 13,475 | 13,475 |
| Derivative assets | 7,514 | 7,514 | 7,787 | 7,787 |
| REO (1) | 3,323 | 3,767 | 3,661 | 4,084 |
| Margin receivable (1) | 58,455 | 58,455 | 31,149 | 31,149 |
| Other collateral posted (1) | 5,000 | 5,000 | 5,000 | 5,000 |
| **Liabilities** | | | | |
| Short-term debt | $ 1,718,430 | $ 1,718,430 | $ 862,763 | $ 862,763 |
| Accrued interest payable | 7,154 | 7,154 | 6,366 | 6,366 |
| Derivative liabilities | 39,837 | 39,837 | 18,167 | 18,167 |
| ABS issued | 1,768,078 | 1,656,135 | 1,942,962 | 1,746,906 |
| Commercial long-term debt | 52,916 | 52,916 | 49,467 | 49,467 |
| Commercial secured borrowings | 66,692 | 66,692 | - | - |
| Convertible notes | 287,500 | 296,700 | 287,500 | 299,719 |
| Other long-term debt | 139,500 | 110,903 | 139,500 | 111,600 |

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

We elected the fair value option for $1.74 billion and $2.82 billion of residential loans (principal balance) and $149 million and $268 million of commercial loans (principal balance) we acquired during the three and six months ended June 30, 2014, respectively. We also elected the fair value option for $30 million and $65 million of commercial secured borrowings we recorded during the three and six months ended June 30, 2014, respectively. We anticipate electing the fair value option for all future purchases of residential loans and commercial senior loans that we intend to sell to third parties or transfer to securitizations.

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**Note 5. Fair Value of Financial Instruments — (continued)**

The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at June 30, 2014, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

***Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2014***

| June 30, 2014 | Carrying | Fair Value Measurements Using | | |
|---|---|---|---|---|
| (In Thousands) | Value | Level 1 | Level 2 | Level 3 |
| **Assets** | | | | |
| Residential loans, at fair value | $ 1,106,239 | $ - | $ 259,675 | $ 846,564 |
| Commercial loans, at fair value | 122,118 | - | - | 122,118 |
| Trading securities | 173,281 | - | - | 173,281 |
| Available-for-sale securities | 1,671,786 | - | - | 1,671,786 |
| MSRs | 71,225 | - | - | 71,225 |
| Derivative assets | 7,514 | 3,295 | 2,513 | 1,707 |
| **Liabilities** | | | | |
| Derivative liabilities | 39,837 | 6,034 | 33,758 | 45 |
| Commercial secured borrowings | 66,692 | - | - | 66,692 |

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the six months ended June 30, 2014.

***Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis***

| | Assets | | | | | | Liabilities |
|---|---|---|---|---|---|---|---|
| (In Thousands) | Residential Loans | Commercial Loans | Trading Securities | AFS Securities | MSRs | Derivatives (1) | Commercial Secured Borrowings |
| Beginning balance - December 31, 2013 | $ 391,100 | $ 89,111 | $ 124,555 | $ 1,558,306 | $ 64,824 | $ (379) | $ - |
| Principal paydowns | (11,563) | (3,463) | (2,714) | (92,590) | - | - | (115) |
| Gains (losses) in net income, net | 21,849 | 11,099 | (13,133) | 23,485 | (8,265) | 5,108 | 1,759 |
| Unrealized gains in OCI, net | - | - | - | 32,888 | - | - | - |
| Acquisitions | 1,717,244 | 271,424 | 64,573 | 151,010 | 14,666 | - | 65,048 |
| Sales | (1,269,330) | (246,053) | - | (1,313) | - | - | - |
| Other settlements, net | (2,736) | - | - | - | - | (3,067) | - |
| **Ending Balance - June 30, 2014** | $ 846,564 | $ 122,118 | $ 173,281 | $ 1,671,786 | $ 71,225 | $ 1,662 | $ 66,692 |

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

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**Note 5. Fair Value of Financial Instruments — (continued)**

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at June 30, 2014 and 2013. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and six months ended June 30, 2014 and 2013 are not included in this presentation.

***Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2014 and 2013 Included in Net Income***

| | Included in Net Income | | | |
|---|---|---|---|---|
| | Three Months Ended June 30, | | Six Months Ended June 30, | |
| (In Thousands) | 2014 | 2013 | 2014 | 2013 |
| **Assets** | | | | |
| Residential loans, at fair value | $ 11,755 | $ (59,649) | $ 11,964 | $ (59,641) |
| Commercial loans, at fair value | 2,008 | - | 2,008 | - |
| Trading securities | (9,257) | 31,354 | (13,688) | 30,866 |
| Available-for-sale securities | (264) | (1,642) | (377) | (1,665) |
| MSRs | (4,974) | 9,450 | (7,236) | 9,532 |
| **Liabilities** | | | | |
| Loan purchase commitments | 1,707 | - | 1,707 | - |
| Commercial secured borrowing | 1,759 | - | 1,759 | - |

The following table presents information on assets recorded at fair value on a non-recurring basis at June 30, 2014. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at June 30, 2014.

***Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at June 30, 2014***

| June 30, 2014 | Carrying | Fair Value Measurements Using | | | Gain (Loss) for | |
|---|---|---|---|---|---|---|
| (In Thousands) | Value | Level 1 | Level 2 | Level 3 | Three Months Ended June 30, 2014 | Six Months Ended June 30, 2014 |
| **Assets** | | | | | | |
| Residential loans, at lower of cost or fair value | $ 1,107 | $ - | $ - | $ 1,107 | $ 1 | $ (2) |
| REO | 2,326 | - | - | 2,326 | (521) | (343) |

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**Note 5. Fair Value of Financial Instruments — (continued)**

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the three and six months ended June 30, 2014 and 2013.

*Market Valuation Adjustments, Net*

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (In Thousands) | 2014 | 2013 | 2014 | 2013 |
| **Mortgage banking activities** | | | | |
| Residential loans, at fair value | $ 13,375 | $ (41,405) | $ 20,403 | $ (6,535) |
| Commercial loans, at fair value | 5,714 | (345) | 9,340 | (345) |
| Trading securities | (8,810) | 36,336 | (13,087) | 38,265 |
| Derivative instruments, net | (8,673) | 49,544 | (15,755) | 50,567 |
| Loan purchase and forward sale commitments | 3,582 | - | 3,590 | - |
| **Total mortgage banking activities** (1) | 5,188 | 44,130 | 4,491 | 81,952 |
| **MSRs** | (5,553) | 8,827 | (8,265) | 9,169 |
| **Other** | | | | |
| Residential loans, at lower of cost or fair value | 13 | 38 | 11 | 78 |
| Trading securities | 77 | (4,140) | (76) | (4,707) |
| Impairments on AFS securities | (264) | (1,642) | (377) | (1,665) |
| REO | (321) | (558) | (464) | (331) |
| Other derivative instruments, net | (3,626) | 44 | (9,354) | 64 |
| **Total other** | (4,121) | (6,258) | (10,260) | (6,561) |
| **Total Market Valuation Adjustments, Net** | $ (4,486) | $ 46,699 | $ (14,034) | $ 84,560 |

(1) Income from mortgage banking activities presented above does not include fee income that is a component of mortgage banking income presented on our consolidated statements of income as it does not represent a market valuation adjustment.

*Valuation Policy*

We maintain a policy that specifies the methodologies we use to value different types of financial instruments. Significant changes to the valuation methodologies are reviewed by members of senior management to confirm the changes are appropriate and reasonable. Valuations based on information from external sources are performed on an instrument-by-instrument basis with the resulting amounts analyzed individually against internal calculations as well as in the aggregate by product type classification. Initial valuations are performed by our portfolio management group using the valuation processes described below. A subset of our finance department then independently reviews all fair value estimates using available market, portfolio, and industry information to ensure they are reasonable. Finally, members of senior management review all fair value estimates, including an analysis of valuation changes from prior reporting periods.

*Valuation Process*

We estimate fair values for financial assets or liabilities based on available inputs observed in the marketplace as well as unobservable inputs. We primarily use two pricing valuation techniques: market comparable pricing and discounted cash flow analysis. Market comparable pricing is used to determine the estimated fair value of certain instruments by incorporating known inputs and performance metrics, such as observed prepayment rates, delinquencies, credit support, recent transaction prices, pending transactions, or prices of other similar instruments. Discounted cash flow analysis techniques generally consist of developing an estimate of future cash flows that are expected to occur over the life of an instrument and then discounting those cash flows at a rate of return that results in an estimate of fair value. After considering all available indications of the appropriate rate of return that market participants would require, we consider the reasonableness of the range indicated by the results to determine an estimate that is most representative of fair value. We also consider counterparty credit quality and risk as part of our fair value assessments.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 5. Fair Value of Financial Instruments — (continued)**

The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

***Fair Value Methodology for Level 3 Financial Instruments***

| June 30, 2014 (Dollars in Thousands) | Fair Value | Unobservable Input | Range | Weighted Average |
|---|---|---|---|---|
| **Assets** | | | | |
| Residential loans, at fair value: | | | | |
| Loans priced to securitization or priced to whole loan market and uncommitted to sell | $ 417,941 | Discount rate | 3 - 4 % | 4 % |
| | | Prepayment rate | 10 - 10 % | 10 % |
| | | Default rate | 1 - 1 % | 1 % |
| | | Loss severity | 22 - 22 % | 22 % |
| | | Credit support | 6 - 8 % | 8 % |
| | | Spread to securitization | 50 bps - 50 bps | 50 bps |
| Loans priced to whole loan market, committed to sell | 428,624 | Pool fallout assumption | 10 bps - 10 bps | 10 bps |
| Residential loans, at lower of cost or fair value | 1,107 | Loss severity | 15-28 % | 21 % |
| Commercial loans, at fair value | 122,118 | Credit spread | 136 bps - 136 bps | 136 bps |
| | | Credit support | 24 - 24 % | 24 % |
| Trading and AFS securities | 1,845,067 | Discount rate | 4 - 12 % | 6 % |
| | | Prepayment speed | 1 - 35 % | 14 % |
| | | Default rate | 0 - 35 % | 7 % |
| | | Loss severity | 20 - 64 % | 33 % |
| | | Credit support | 0 - 84 % | 6 % |
| MSRs | 71,225 | Discount rate | 9 - 11 % | 11 % |
| | | Prepayment rate | 6 - 60 % | 12 % |
| REO | 2,326 | Loss severity | 0 - 93 % | 18 % |
| Loan purchase commitments, net (1) | 1,662 | MSR Multiple | 1 - 5x | 4x |
| | | Pullthrough rate | 57 - 99 % | 81 % |
| **Liabilities** | | | | |
| Commercial secured financing | 66,692 | Credit spread | 136 bps - 136 bps | 136 bps |
| | | Credit support | 24 - 24 % | 24 % |

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

***Determination of Fair Value***

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

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**Note 5. Fair Value of Financial Instruments — (continued)**

***Residential loans***

Estimated fair values for residential loans are determined based on either an exit price to securitization or the whole loan market. For loans valued based on an exit to securitization, significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the limited availability of market quotes on newly issued Residential Mortgage-Backed Securities (“RMBS”) and related inputs. Relevant market indicators that are factored into the analyses include third-party RMBS sales, pricing points for secondary sales of RMBS we have issued in past periods, yields for RMBS issued by government sponsored enterprises, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued RMBS transactions, interest rates, and prepayment speeds (Level 3).

For loans valued based on an exit to the whole loan market, significant inputs in the valuation analysis are predominantly Level 3 in nature. Relevant market indicators that are factored into the analyses include prices on recent sales of our own whole loans, indexed swap yields, interest rates, prepayment speeds, and loss severities (Level 3). These assets would generally decrease in value based upon an increase in the loss severity assumption and would generally increase in value if the loss severity assumption were to decrease.

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

*Commercial loans*

Estimated fair values for senior commercial loans are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses include third-party Commercial Mortgage-Backed Securities (“CMBS”) sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for the securities for purchase into securitization (Level 2).

Estimated fair values for mezzanine commercial loans are determined by both market comparable pricing and discounted cash flow analysis valuation techniques (Level 3). Our discounted cash flow models utilize certain significant unobservable inputs including the underwritten net operating income and debt coverage ratio assumptions and actual performance relative to those underwritten metrics. A decrease in these unobservable inputs will reduce the estimated fair value of the commercial loans.

*Real estate securities*

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

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at June 30, 2014, we received dealer price indications on 79% of our securities, representing 90% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were within 2% of the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**Note 5. Fair Value of Financial Instruments — (continued)**

*Derivative assets and liabilities*

Our derivative instruments include swaps, swaptions, TBAs, financial futures, CMBX credit default index swaps, LPCs, and FSCs. Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets. TBA and financial futures fair values are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2). LPC fair values are estimated based on quoted Agency MBS prices, estimates of the fair value of the MSRs we expect to retain in the sale of the loans, and the probability that the mortgage loan will be purchased (Level 3). FSC fair values are obtained using quoted Agency prices. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2).

For other derivatives, valuations are based on various factors such as liquidity, bid/ask spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management's best estimate is used (Level 3).

*MSRs*

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

As part of our MSR valuation process, we received a valuation estimate from a third-party valuations group. In the aggregate, our internal valuation of the MSRs was 2% lower than the third-party valuation at June 30, 2014.

*Cash and cash equivalents*

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

*Restricted cash*

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

*Accrued interest receivable and payable*

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

*REO*

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**Note 5. Fair Value of Financial Instruments — (continued)**

*Margin receivable*

Margin receivable reflects cash collateral we have posted with our various derivative and debt counterparties as required to satisfy margin requirements. Fair values approximate carrying values (Level 1).

*Short-term debt*

Short-term debt includes our credit facilities that mature within one year. Fair values approximate carrying values (Level 1).

*ABS issued*

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

As part of our ABS issued valuation process, we also request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at June 30, 2014, we received dealer price indications on 42% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were within 1% of the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis.

*Commercial long-term debt*

Commercial long-term debt includes our commercial loan repurchase agreement that matures in more than one year. Fair values approximate carrying values (Level 1).

*Commercial secured borrowings*

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

*Convertible notes*

Convertible notes include unsecured convertible senior notes. Fair values are determined using quoted prices in active markets (Level 1).

*Trust preferred securities and subordinated notes*

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 6. Residential Loans**

We acquire residential loans from third-party originators. The following table summarizes the classifications and carrying value of the residential loans owned at Redwood and at consolidated Sequoia entities at June 30, 2014 and December 31, 2013.

| June 30, 2014<br>(In Thousands) | Redwood | Sequoia | Total |
|---|---|---|---|
| Held-for-sale | | | |
| Fair value - Conforming | $ 259,675 | $ - | $ 259,675 |
| Fair value - Jumbo | 846,564 | - | 846,564 |
| Lower of cost or fair value | 1,638 | - | 1,638 |
| Held-for-investment | - | 1,616,504 | 1,616,504 |
| **Total Residential Loans** | $ 1,107,877 | $ 1,616,504 | $ 2,724,381 |

| December 31, 2013<br>(In Thousands) | Redwood | Sequoia | Total |
|---|---|---|---|
| Held-for-sale | | | |
| Fair value - Conforming | $ 11,502 | $ - | $ 11,502 |
| Fair value - Jumbo | 391,100 | - | 391,100 |
| Lower of cost or fair value | 1,665 | - | 1,665 |
| Held-for-investment | - | 1,762,167 | 1,762,167 |
| **Total Residential Loans** | $ 404,267 | $ 1,762,167 | $ 2,166,434 |

***Residential Loans Held-for-Sale***

*Residential Loans at Fair Value*

At June 30, 2014, there were 2,038 residential loans at fair value, with an aggregate outstanding principal balance of $1.07 billion and an aggregate fair value of $1.11 billion. During the three and six months ended June 30, 2014, we purchased $1.74 billion and $2.82 billion (principal balance) of residential loans, respectively, for which we elected the fair value option. During the three and six months ended June 30, 2014, we recorded $13 million and $20 million of positive valuation adjustments, respectively, on fair value residential loans through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2013, there were 537 residential loans at fair value, with an aggregate outstanding principal balance of $399 million and an aggregate fair value of $403 million.

*Residential Loans at Lower of Cost or Fair Value*

At June 30, 2014, there were 10 residential loans at lower of cost or fair value with $2 million in outstanding principal balance and a carrying value of $2 million. At December 31, 2013, there were 10 residential loans at lower of cost or fair value with $2 million in outstanding principal balance and a carrying value of $2 million. During the three and six months ended June 30, 2014, we recorded valuation adjustments for residential loans held-for-sale of positive $13 thousand and $11 thousand, respectively.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**Note 6. Residential Loans — (continued)**

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

The following table details the carrying value for residential loans held-for-investment at June 30, 2014 and December 31, 2013. These loans are owned at Sequoia securitization entities that we consolidate for financial reporting purposes.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Principal balance | $ 1,625,890 | $ 1,770,803 |
| Unamortized premium, net | 14,586 | 16,791 |
| Recorded investment | 1,640,476 | 1,787,594 |
| Allowance for loan losses | (23,972) | (25,427) |
| **Carrying Value** | $ 1,616,504 | $ 1,762,167 |

Of the $1.6 billion of principal balance and $15 million of unamortized premium on loans held-for-investment at June 30, 2014, $663 million of principal balance and $9 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the six months ended June 30, 2014, 9% of these residential loans prepaid and we amortized 16% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal balance was $966 million and the unamortized premium was $6 million. During the six months ended June 30, 2014, 7% of these loans prepaid and we amortized 9% of the premium.

Of the $1.77 billion of principal balance and $17 million of unamortized premium on loans held-for-investment at December 31, 2013, $731 million of principal balance and $11 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal balance was $1 billion and the unamortized premium was $6 million.

***Credit Characteristics of Residential Loans Held-for-Investment***

As a percentage of our recorded investment, 99% of residential loans held-for-investment at June 30, 2014, were first lien, predominately prime-quality loans at the time of origination. The remaining 1% of loans were second lien, home equity lines of credit. The weighted average original LTV ratio for our residential loans held-for-investment outstanding at June 30, 2014, was 66%. The weighted average FICO score for the borrowers of these loans was 733 at the time the loans were originated.

We consider the year of origination of our residential loans held-for-investment to be a general indicator of credit performance as loans originated in specific years have often possessed similar product and credit characteristics. The following table displays our recorded investment in residential loans held-for-investment at June 30, 2014 and December 31, 2013, organized by year of origination.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| 2003 & Earlier | $ 798,571 | $ 881,364 |
| 2004 | 479,478 | 513,458 |
| 2005 | 60,138 | 62,675 |
| 2006 | 141,937 | 149,776 |
| 2007 | - | - |
| 2008 | - | - |
| 2009 | 19,994 | 25,860 |
| 2010 | 84,992 | 92,728 |
| 2011 | 55,366 | 61,733 |
| **Total Recorded Investment** | $ 1,640,476 | $ 1,787,594 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 6. Residential Loans — (continued)**

***Allowance for Loan Losses on Residential Loans***

For residential loans held-for-investment, we establish and maintain an allowance for loan losses. The allowance includes a component for pools of residential loans owned at Sequoia securitization entities that we collectively evaluated for impairment, and a component for loans individually evaluated for impairment that includes modified residential loans at Sequoia entities that have been determined to be troubled debt restructurings.

***Activity in the Allowance for Loan Losses on Residential Loans***

The following table summarizes the activity in the allowance for loan losses for the three and six months ended June 30, 2014 and 2013.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Balance at beginning of period | $ 25,571 | $ 29,064 | $ 25,427 | $ 28,504 |
| Charge-offs, net | (994) | (1,751) | (1,478) | (2,545) |
| (Reversal of provision) provision for loan losses | (605) | (4,163) | 23 | (2,809) |
| **Balance at End of Period** | $ 23,972 | $ 23,150 | $ 23,972 | $ 23,150 |

During the three months ended June 30, 2014 and 2013, there were less than $1 million and $2 million of charge-offs of residential loans that reduced our allowance for loan losses, respectively. These charge-offs were from $6 million and $5 million of defaulted loan principal, respectively. During the six months ended June 30, 2014 and 2013, there were $1 million and $3 million of charge-offs of residential loans, respectively, that reduced our allowance for loan losses. These charge-offs arose from $8 million and $7 million of defaulted loan principal, respectively.

***Residential Loans Collectively Evaluated for Impairment***

We establish the collective component of the allowance for residential loan losses based primarily on the characteristics of the loan pools underlying the securitization entities that own the loans, including loan product types, credit characteristics, and origination years. The collective analysis is further divided into two segments. The first segment reflects our estimate of losses on delinquent loans within each loan pool. These loss estimates are determined by applying the loss factors described in Note 3 to the delinquent loans, including our expectations of the timing of defaults and the loss severities we expect once defaults occur. The second segment relates to our estimate of losses incurred on nondelinquent loans within each loan pool. This estimate is based on losses we expect to realize over a 23 month loss confirmation period, which is based on our historical loss experience as well as consideration of the loss factors described in *Note 3*.

The following table summarizes the balances for loans collectively evaluated for impairment at June 30, 2014 and December 31, 2013.

| **(In Thousands)** | **June 30, 2014** | **December 31, 2013** |
|---|---|---|
| Principal balance | $ 1,612,303 | $ 1,762,165 |
| Recorded investment | 1,627,228 | 1,779,161 |
| Related allowance | 22,695 | 24,762 |

The following table summarizes the recorded investment and past due status of residential loans collectively evaluated for impairment at June 30, 2014 and December 31, 2013.

| **(In Thousands)** | **30-59 Days Past Due** | **60-89 Days Past Due** | **90+ Days Past Due** | **Current** | **Total Loans** |
|---|---|---|---|---|---|
| June 30, 2014 | $ 25,639 | $ 9,619 | $ 74,393 | $ 1,517,577 | $ 1,627,228 |
| December 31, 2013 | 34,187 | 13,248 | 79,010 | 1,652,716 | 1,779,161 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 6. Residential Loans — (continued)**

***Residential Loans Individually Evaluated for Impairment***

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for qualifying borrowers and potentially reduce a future impairment. For the six months ended June 30, 2014 and 2013, all of the loan modifications determined to be TDRs were either: (i) conversions of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reductions in the contractual interest rates of a mortgage loan paired with capitalization of accrued interest; or (iii) principal forgiveness paired with interest rate reductions.

The following table presents the details of the loan modifications determined to be TDRs for the three and six months ended June 30, 2014 and 2013.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(Dollars in Thousands)** | **2014** | **2013** | **2014** | **2013** |
| **TDRs** | | | | |
| Number of modifications | 9 | 4 | 14 | 7 |
| Pre-modification outstanding recorded investment | $ 3,052 | $ 1,031 | $ 4,967 | $ 1,795 |
| Post-modification outstanding recorded investment | 3,272 | 1,145 | 5,165 | 1,941 |
| Loan modification effect on net interest income after provision and other MVA | (812) | (140) | (1,221) | (309) |
| | | | | |
| **TDRs that Subsequently Defaulted** | | | | |
| Number of modifications | 3 | 1 | 6 | 3 |
| Recorded investment | $ 1,574 | $ 178 | $ 2,493 | $ 587 |

If we determine that a restructured loan is a TDR, we remove it from the general loan pools used for determining the allowance for residential loan losses and assess it for impairment on an individual basis. This assessment is based primarily on whether an adverse change in the expected future cash flows resulted from the restructuring. The average recorded investment of loans for the three months ended June 30, 2014 and 2013 was $13 million and $7 million, respectively. The average recorded investment of loans individually evaluated for impairment for the six months ended June 30, 2014 and 2013 was $11 million and $7 million, respectively. For the three months ended June 30, 2014 and 2013, we recorded interest income of $29 thousand and $10 thousand, respectively, on individually impaired loans. For the six months ended June 30, 2014 and 2013, we recorded interest income of $67 thousand and $21 thousand, respectively, on individually impaired loans.

The following table summarizes the balances for loans individually evaluated for impairment, all of which had an allowance, at June 30, 2014 and December 31, 2013.

| **(In Thousands)** | **June 30, 2014** | **December 31, 2013** |
|---|---|---|
| Principal balance | $ 13,587 | $ 8,638 |
| Recorded investment | 13,248 | 8,433 |
| Related allowance | 1,277 | 665 |

The following table summarizes the recorded investment and past due status of residential loans individually evaluated for impairment at June 30, 2014 and December 31, 2013.

| **(In Thousands)** | **30-59 Days Past Due** | **60-89 Days Past Due** | **90+ Days Past Due** | **Current** | **Total Loans** |
|---|---|---|---|---|---|
| June 30, 2014 | $ 1,611 | $ 1,319 | $ 551 | $ 9,767 | $ 13,248 |
| December 31, 2013 | 1,560 | - | 567 | 6,306 | 8,433 |

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 7. Commercial Loans**

We invest in commercial loans that we originate and service as well as loans that we acquire from third-party originators. The following table summarizes the classifications and carrying value of commercial loans at June 30, 2014 and December 31, 2013.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Held-for-sale, at fair value | $ 50,848 | $ 89,111 |
| Held-for-investment | | |
| At fair value | 71,270 | - |
| At amortized cost | 346,648 | 343,344 |
| **Total Commercial Loans** | $ 468,766 | $ 432,455 |

Of the held-for-investment commercial loans shown above at June 30, 2014 and December 31, 2013, $255 million and $258 million, respectively, were financed through the Commercial Securitization entity, as discussed in *Note 4*.

***Commercial Loans Held-for-Sale***

Commercial loans held-for-sale include loans we originate and intend to sell to third parties. At June 30, 2014, there were seven commercial loans at fair value, with an aggregate outstanding principal balance of $49 million and an aggregate fair value of $51 million. During the three and six months ended June 30, 2014, we originated and funded senior commercial loans for $149 million and $237 million and recorded $6 million and $8 million of positive valuation adjustments on commercial loans held-for-sale through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2013, there were seven senior commercial loans at fair value, with an aggregate outstanding principal balance of $88 million and an aggregate fair value of $89 million.

***Commercial Loans Held-for-Investment***

*Commercial Loans Held-for-Investment, at Fair Value*

Commercial loans held-for-investment at fair value include certain loans we hold for investment for which we have elected the fair value option. At June 30, 2014, there were three of these commercial loans, with an aggregate outstanding principal balance of $68 million and an aggregate fair value of $71 million. During the three months ended June 30, 2014, we did not originate any commercial loans held-for-investment at fair value and recorded $2 million of positive valuation adjustments on our existing portfolio. During the six months ended June 30, 2014, we originated and funded commercial loans for $31 million and recorded $3 million of positive valuation adjustments on commercial loans held-for-investment at fair value through mortgage banking activities, net, a component of our consolidated income statement. We did not have any commercial loans held-for-investment at fair value at December 31, 2013.

*Commercial Loans Held-for-Investment, at Amortized Cost*

Commercial loans held-for-investment at amortized cost include loans we originate and preferred equity investments we make or, in either case, acquire from third parties. Through June 30, 2014, these loans have typically been mezzanine loans that are secured by a borrower's ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. The preferred equity investments are typically preferred equity interests in a single purpose entity that owns commercial property and are included within, and referred to herein, as commercial loans held-for-investment due to the fact that their risks and payment characteristics are nearly equivalent to commercial mezzanine loans.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**Note 7. Commercial Loans — (continued)**

The following table provides additional information for our commercial loans held-for-investment at amortized cost at June 30, 2014 and December 31, 2013.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Principal balance | $ 357,292 | $ 353,331 |
| Unamortized discount, net | (2,327) | (2,614) |
| Recorded investment | 354,965 | 350,717 |
| Allowance for loan losses | (8,317) | (7,373) |
| **Carrying Value** | $ 346,648 | $ 343,344 |

At June 30, 2014, there were 53 commercial loans held-for-investment at amortized cost with an outstanding principal balance of $357 million and a carrying value of $347 million. During the three and six months ended June 30, 2014, we originated or acquired $6 million and $8 million of commercial loans held-for-investment at amortized cost. Of the $355 million of recorded investment in commercial loans held-for-investment at June 30, 2014, 2% was originated in 2014, 18% was originated in 2013, 43% was originated in 2012, 33% was originated in 2011, and 4% was originated in 2010.

At December 31, 2013, there were 50 commercial loans held-for-investment at amortized cost with an outstanding principal balance of $353 million and a carrying value of $343 million. Of the $351 million of recorded investment in commercial loans held-for-investment at December 31, 2013, 19% was originated in 2013, 43% was originated in 2012, 34% was originated in 2011, and 4% was originated in 2010.

***Allowance for Loan Losses on Commercial Loans***

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

Our methodology for assessing the adequacy of the allowance for loan losses includes a formal review of each commercial loan in the portfolio and the assignment of an internal impairment status. Based on the assigned impairment status, a loan is categorized as “Pass,” “Watch List,” or “Workout.” The following table presents the principal balance of commercial loans held-for-investment by risk category.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Pass | $ 331,558 | $ 309,792 |
| Watch list | 25,734 | 43,539 |
| Workout | - | - |
| **Total Commercial Loans Held-for-Investment** | $ 357,292 | $ 353,331 |

***Activity in the Allowance for Loan Losses on Commercial Loans***

The following table summarizes the activity in the allowance for commercial loan losses for the three and six months ended June 30, 2014 and 2013.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (In Thousands) | 2014 | 2013 | 2014 | 2013 |
| Balance at beginning of period | $ 8,028 | $ 4,769 | $ 7,373 | $ 4,084 |
| Charge-offs, net | - | - | - | - |
| Provision for loan losses | 289 | 891 | 944 | 1,576 |
| **Balance at End of Period** | $ 8,317 | $ 5,660 | $ 8,317 | $ 5,660 |

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 7. Commercial Loans — (continued)**

***Commercial Loans Collectively Evaluated for Impairment***

At June 30, 2014 and December 31, 2013, all of our commercial loans collectively evaluated for impairment were current. The following table summarizes the balances for loans collectively evaluated for impairment at June 30, 2014 and December 31, 2013.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Principal balance | $ 357,292 | $ 353,331 |
| Recorded investment | 354,965 | 350,717 |
| Related allowance | 8,317 | 7,373 |

***Commercial Loans Individually Evaluated for Impairment***

We did not have any commercial loans individually evaluated for impairment at either June 30, 2014 or December 31, 2013.

**Note 8. Real Estate Securities**

We invest in mortgage-backed securities. The following table presents the fair values of our real estate securities by type at June 30, 2014 and December 31, 2013.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Trading | $ 173,281 | $ 124,555 |
| Available-for-sale | 1,671,786 | 1,558,306 |
| **Total Real Estate Securities** | $ 1,845,067 | $ 1,682,861 |

Our residential securities herein are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests.

***Trading Securities***

We elected the fair value option for certain securities and classify them as trading securities. At June 30, 2014, our trading securities included $105 million of interest-only securities, for which there is no principal balance, $62 million of senior securities and $6 million of residential subordinate securities. The unpaid principal balance of residential senior and subordinate securities classified as trading was $62 million and $15 million, respectively, at June 30, 2014. The following table presents trading securities by collateral type at June 30, 2014 and December 31, 2013.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| **Senior Securities** | | |
| Prime | $ 159,311 | $ 110,505 |
| Non-prime | 8,380 | 9,070 |
| **Total Senior Securities** | 167,691 | 119,575 |
| **Subordinate Securities** | | |
| Prime | 5,590 | 4,980 |
| Non-prime | - | - |
| **Total Subordinate Securities** | 5,590 | 4,980 |
| **Total Trading Securities** | $ 173,281 | $ 124,555 |

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 8. Real Estate Securities — (continued)**

***AFS Securities***

The following table presents the fair value of our available-for-sale securities held at Redwood by collateral type at June 30, 2014 and December 31, 2013.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| **Senior Securities** | | |
| Prime | $ 711,710 | $ 662,306 |
| Non-prime | 192,256 | 193,386 |
| **Total Senior Securities** | 903,966 | 855,692 |
| **Re-REMIC Securities** | 192,596 | 176,376 |
| **Subordinate Securities** | | |
| Prime | 575,067 | 526,095 |
| Non-prime | 157 | 143 |
| **Total Subordinate Securities** | 575,224 | 526,238 |
| **Total AFS Securities** | $ 1,671,786 | $ 1,558,306 |

The senior securities shown above at June 30, 2014 and December 31, 2013, included $119 million and $131 million, respectively, of prime securities, and $127 million and $132 million, respectively, of non-prime securities that were financed through the Residential Resecuritization entity, as discussed in *Note 4*.

We often purchase AFS securities at a discount to their outstanding principal balances. To the extent we purchase an AFS security that has a likelihood of incurring a loss, we do not amortize into income the portion of the purchase discount that we do not expect to collect due to the inherent credit risk of the security. We may also expense a portion of our investment in the security to the extent we believe that principal losses will exceed the purchase discount. We designate any amount of unpaid principal balance that we do not expect to receive and thus do not expect to earn or recover as a credit reserve on the security. Any remaining net unamortized discounts or premiums on the security are amortized into income over time using the effective yield method.

At June 30, 2014, there were $10 million of AFS residential securities with contractual maturities less than five years, $2 million of AFS residential securities with contractual maturities greater than five years but less than ten years, and the remainder of our real estate securities had contractual maturities greater than ten years.

The following table presents the components of carrying value (which equals fair value) of residential AFS securities at June 30, 2014 and December 31, 2013.

***Carrying Value of Residential AFS Securities***

| June 30, 2014 | Senior | | | | |
|---|---|---|---|---|---|
| (In Thousands) | Prime | Non-prime | Re-REMIC | Subordinate | Total |
| Principal balance | $ 710,620 | $ 209,967 | $ 223,389 | $ 717,838 | $ 1,861,814 |
| Credit reserve | (5,476) | (9,697) | (17,788) | (50,315) | (83,276) |
| Unamortized discount, net | (37,763) | (36,387) | (89,089) | (141,054) | (304,293) |
| Amortized cost | 667,381 | 163,883 | 116,512 | 526,469 | 1,474,245 |
| Gross unrealized gains | 45,952 | 28,385 | 76,084 | 54,289 | 204,710 |
| Gross unrealized losses | (1,623) | (12) | - | (5,534) | (7,169) |
| **Carrying Value** | $ 711,710 | $ 192,256 | $ 192,596 | $ 575,224 | $ 1,671,786 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**Note 8. Real Estate Securities — (continued)**

| **December 31, 2013 (In Thousands)** | **Senior** | | | | |
|---|---|---|---|---|---|
| | **Prime** | **Non-prime** | **Re-REMIC** | **Subordinate** | **Total** |
| Principal balance | $ 670,051 | $ 218,603 | $ 214,046 | $ 706,292 | $ 1,808,992 |
| Credit reserve | (10,144) | (13,840) | (30,429) | (62,457) | (116,870) |
| Unamortized discount, net | (44,133) | (36,882) | (80,188) | (137,266) | (298,469) |
| Amortized cost | 615,774 | 167,881 | 103,429 | 506,569 | 1,393,653 |
| Gross unrealized gains | 47,980 | 25,654 | 72,947 | 41,205 | 187,786 |
| Gross unrealized losses | (1,448) | (149) | - | (21,536) | (23,133) |
| **Carrying Value** | $ 662,306 | $ 193,386 | $ 176,376 | $ 526,238 | $ 1,558,306 |

The following table presents the changes for the three and six months ended June 30, 2014, in unamortized discount and designated credit reserves on residential AFS securities.

***Changes in Unamortized Discount and Designated Credit Reserves on Residential AFS Securities***

| **(In Thousands)** | **Three Months Ended June 30, 2014** | |
|---|---|---|
| | **Credit Reserve** | **Unamortized Discount, Net** |
| Beginning balance | $ 95,688 | $ 303,733 |
| Amortization of net discount | - | (10,586) |
| Realized credit losses | (3,973) | - |
| Acquisitions | 257 | 3,246 |
| Sales, calls, other | (476) | (584) |
| Impairments | 264 | - |
| Transfers to (release of) credit reserves, net | (8,484) | 8,484 |
| **Ending Balance** | $ 83,276 | $ 304,293 |

| **(In Thousands)** | **Six Months Ended June 30, 2014** | |
|---|---|---|
| | **Credit Reserve** | **Unamortized Discount, Net** |
| Beginning balance | $ 116,870 | $ 298,469 |
| Amortization of net discount | - | (21,884) |
| Realized credit losses | (7,310) | - |
| Acquisitions | 257 | 2,837 |
| Sales, calls, other | (1,412) | (635) |
| Impairments | 377 | - |
| Transfers to (release of) credit reserves, net | (25,506) | 25,506 |
| **Ending Balance** | $ 83,276 | $ 304,293 |

***Residential AFS Securities with Unrealized Losses***

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at June 30, 2014 and December 31, 2013.

| **(In Thousands)** | **Less Than 12 Consecutive Months** | | | **12 Consecutive Months or Longer** | | |
|---|---|---|---|---|---|---|
| | **Amortized Cost** | **Unrealized Losses** | **Fair Value** | **Amortized Cost** | **Unrealized Losses** | **Fair Value** |
| June 30, 2014 | $ 300,804 | $ (2,691) | $ 298,113 | $ 122,012 | $ (4,478) | $ 117,534 |
| December 31, 2013 | 607,030 | (21,195) | 585,835 | 19,828 | (1,938) | 17,890 |

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 8. Real Estate Securities — (continued)**

At June 30, 2014, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 306 AFS securities, of which 44 were in an unrealized loss position and 16 were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2013, our consolidated balance sheet included 303 AFS securities, of which 76 were in an unrealized loss position and five were in a continuous unrealized loss position for 12 consecutive months or longer.

***Evaluating AFS Securities for Other-than-Temporary Impairments***

Gross unrealized losses on our AFS securities were $7 million at June 30, 2014. We evaluate all securities in an unrealized loss position to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). At June 30, 2014, we did not intend to sell any of our AFS securities that were in an unrealized loss position, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity. We review our AFS securities that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent security performance and expected future performance of the underlying collateral.

During the three months ended June 30, 2014, we determined that unrealized losses of $3 million related to our AFS securities were OTTI, of which $264 thousand was determined to be credit related and recorded in “Other market valuation adjustments” in our consolidated statements of income and $2.7 million was determined to be non-credit related and recorded through AOCI on our consolidated balance sheets. AFS securities on which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. In determining our estimate of cash flows for AFS securities we may consider factors such as structural credit enhancement, past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, which are informed by prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, and geographic concentrations, as well as general market assessments. Changes in our evaluation of these factors impacted the cash flows expected to be collected at the OTTI assessment date and were used to determine if there were credit-related adverse cash flows and if so, the amount of credit related losses. Significant judgment is used in both our analysis of the expected cash flows for our AFS securities and any determination of the credit loss component of OTTI.

The table below summarizes the significant valuation assumptions we used for our OTTI AFS securities at June 30, 2014.

***Significant Valuation Assumptions***

| | Range for Securities | |
|---|---|---|
| **June 30, 2014** | **Prime Securities** | **Non-prime** |
| Prepayment rates | 7 - 20 % | 10 - 10 % |
| Loss severity | 20 - 53 % | 35 - 35 % |
| Projected default rate | 1 - 20 % | 11 - 11 % |

The following table details the activity related to the credit loss component of OTTI (i.e., OTTI recognized through earnings) for AFS securities held at June 30, 2014 and 2013, for which a portion of an OTTI was recognized in other comprehensive income.

***Activity of the Credit Component of Other-than-Temporary Impairments***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Balance at beginning of period | $ 35,786 | $ 45,611 | $ 37,149 | $ 50,852 |
| Additions | | | | |
| Initial credit impairments | 190 | - | 261 | - |
| Subsequent credit impairments | 28 | - | 70 | - |
| Reductions | | | | |
| Securities sold, or expected to sell | (904) | (2,191) | (904) | (2,191) |
| Securities with no outstanding principal at period end | (844) | (746) | (2,320) | (5,987) |
| **Balance at End of Period** | $ 34,256 | $ 42,674 | $ 34,256 | $ 42,674 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 8. Real Estate Securities — (continued)**

***Gross Realized Gains and Losses on AFS Securities***

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains and losses on sales and calls of AFS securities for the three and six months ended June 30, 2014 and 2013.

| (In Thousands) | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| Gross realized gains - sales | $ 992 | $ 193 | $ 992 | $ 12,231 |
| Gross realized gains - calls | - | 333 | 987 | 333 |
| Gross realized losses - sales | - | - | - | - |
| Gross realized losses - calls | - | - | - | - |
| **Total Realized Gains on Sales and Calls of AFS Securities, net** | $ 992 | $ 526 | $ 1,979 | $ 12,564 |

**Note 9. Mortgage Servicing Rights**

We invest in mortgage servicing rights and contract with a licensed sub-servicer to perform all servicing functions for loans associated with our MSRs. The following table presents activity for MSRs for the three and six months ended June 30, 2014 and 2013.

***MSR Activity***

| (In Thousands) | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| Balance at beginning of period | $ 64,971 | $ 18,123 | $ 64,824 | $ 5,315 |
| Additions | 11,807 | 16,148 | 14,666 | 28,614 |
| Changes in fair value due to: | | | | |
| Changes in assumptions (1) | (3,553) | 9,506 | (4,678) | 10,312 |
| Other changes (2) | (2,000) | (679) | (3,587) | (1,143) |
| **Balance at End of Period** | $ 71,225 | $ 43,098 | $ 71,225 | $ 43,098 |

(1) Primarily reflects changes in prepayment assumptions due to changes in interest rates and discount rates.
(2) Represents changes due to realization of expected cash flows.

We make investments in MSRs through the retention of servicing rights associated with the residential mortgage loans that we have acquired and subsequently transfer to third parties or through the direct acquisition of MSRs sold by third parties. The following table details the retention and purchase of MSRs during the three and six months ended June 30, 2014.

***MSR Additions***

| (In Thousands) | Three Months Ended June 30, 2014 | | Six Months Ended June 30, 2014 | |
|---|---|---|---|---|
| | MSR Value | Associated Principal | MSR Value | Associated Principal |
| Jumbo MSR additions: | | | | |
| From securitization | $ 2,186 | $ 257,201 | $ 2,186 | $ 257,201 |
| From loan Sales | - | - | 488 | 58,793 |
| Total jumbo MSR additions | 2,186 | 257,201 | 2,674 | 315,994 |
| Conforming MSR additions: | | | | |
| From loan sales | $ 7,495 | $ 725,339 | $ 9,302 | $ 880,437 |
| From purchases | 2,126 | 213,953 | 2,690 | 273,342 |
| Total conforming MSR additions | 9,621 | 939,292 | 11,992 | 1,153,779 |
| **Total MSR additions** | $ 11,807 | $ 1,196,493 | $ 14,666 | $ 1,469,773 |

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**Note 9. Mortgage Servicing Rights — (continued)**

*MSR Income*

The following table presents the components of our MSR income.

| (In Thousands) | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| Servicing income, net: | | | | |
| Income | $ 4,026 | $ 1,943 | $ 7,624 | $ 2,793 |
| Late charges | 38 | 11 | 73 | 18 |
| Cost of sub-servicer | (288) | (234) | (603) | (412) |
| Net servicing income | 3,776 | 1,720 | 7,094 | 2,399 |
| Market valuation adjustments | (5,553) | 8,827 | (8,265) | 9,169 |
| **Income from MSRs, Net** | $ (1,777) | $ 10,547 | $ (1,171) | $ 11,568 |

**Note 10. Derivative Financial Instruments**

The following table presents the fair value and notional amount of derivative financial instruments held by us at June 30, 2014 and December 31, 2013.

| (In Thousands) | June 30, 2014 Fair Value | June 30, 2014 Notional Amount | December 31, 2013 Fair Value | December 31, 2013 Notional Amount |
|---|---|---|---|---|
| **Assets - Risk Management Derivatives** | | | | |
| Interest rate swaps | $ 4 | $ 4,000 | $ 5,972 | $ 268,000 |
| TBAs | 3,294 | 498,000 | 1,138 | 241,000 |
| Swaptions | 1,921 | 265,000 | 596 | 340,000 |
| CMBX | 588 | 25,000 | - | - |
| **Assets - Other Derivatives** | | | | |
| Loan purchase commitments | 1,707 | 329,914 | - | 360 |
| Loan forward sale commitments | - | - | 81 | 10,000 |
| **Total Assets** | $ 7,514 | $ 1,121,914 | $ 7,787 | $ 859,360 |
| | | | | |
| **Liabilities - Cash Flow Hedges** | | | | |
| Interest rate swaps | $ (30,719) | $ 139,500 | $ (16,519) | $ 139,500 |
| **Liabilities - Risk Management Derivatives** | | | | |
| Interest rate swaps | (1,918) | 291,500 | (80) | 50,500 |
| TBAs | (5,540) | 751,500 | (661) | 235,000 |
| Futures | (494) | 126,000 | (528) | 162,000 |
| **Liabilities - Other Derivatives** | | | | |
| Loan purchase commitments | (45) | 49,565 | (379) | 42,562 |
| Loan forward sale commitments | (1,121) | 245,905 | - | - |
| **Total Liabilities** | $ (39,837) | $ 1,603,970 | $ (18,167) | $ 629,562 |
| **Total Derivative Financial Instruments, Net** | $ (32,323) | $ 2,725,884 | $ (10,380) | $ 1,488,922 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 10. Derivative Financial Instruments — (continued)**

***Risk Management Derivatives***

To offset, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheet, we may enter into derivative contracts. In order to manage certain risks associated with residential loans, residential securities, and commercial loans we own or plan to acquire, at June 30, 2014, we were party to swaps and swaptions with an aggregate notional amount of $560 million, TBA contracts sold with an aggregate notional amount of $1.3 billion and financial futures contracts with an aggregate notional amount of $126 million. Net market valuation adjustments on risk management derivatives were negative $25 million and positive $51 million for the six months ended June 30, 2014 and 2013, respectively.

***Loan Purchase and Forward Sale Commitments***

LPCs and FSCs that qualify as derivatives are recorded at their estimated fair values. Net valuation adjustments on LPCs and FSCs were positive $4 million for the three and six months ended June 30, 2014, respectively, and are reported through our consolidated statements of income in mortgage banking activities, net.

***Derivatives Designated as Cash Flow Hedges***

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

For the three months ended June 30, 2014 and 2013, designated cash flow hedges decreased in value by $5 million and increased in value by $14 million, respectively, which was recorded in accumulated other comprehensive income, a component of equity. For the six months ended June 30, 2014 and 2013, these cash flow hedges decreased in value by $14 million and increased in value by $21 million, respectively. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was $30 million and $16 million at June 30, 2014 and December 31, 2013, respectively. For both of the three months ended June 30, 2014 and 2013, we reclassified less than $100 thousand of unrealized losses on derivatives to interest expense. For the six months ended June 30, 2014 and 2013, we reclassified $99 thousand and $157 thousand, respectively, of unrealized losses on derivatives to interest expense. Accumulated other comprehensive loss of less than $1 million will be amortized into interest expense, a component of our consolidated income statements, over the remaining life of the hedge liabilities.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and six months ended June 30, 2014 and 2013.

***Impact on Interest Expense of Our Interest Rate Agreements Accounted for as Cash Flow Hedges***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Net interest expense on cash flow interest rate agreements | $ (1,490) | $ (1,470) | $ (2,978) | $ (2,934) |
| Realized income (expense) due to ineffective portion of hedges | - | - | - | - |
| Realized net losses reclassified from other comprehensive income | (39) | (69) | (99) | (157) |
| **Total Interest Expense** | $ (1,529) | $ (1,539) | $ (3,077) | $ (3,091) |

***Derivative Counterparty Credit Risk***

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. Each of our derivative counterparties that is not a clearinghouse must maintain compliance with International Swaps and Derivatives Association (“ISDA”) agreements or other similar agreements (or receive a waiver of non-compliance after a specific assessment) in order to conduct derivative transactions with us. Additionally, we reviewnon-clearinghouse derivative counterparty credit standings, and in the case of a deterioration of creditworthiness, appropriate remedial

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 10. Derivative Financial Instruments — (continued)**

action is taken. To further mitigate counterparty risk, we exit derivatives contracts with counterparties that (i) do not maintain compliance with (or obtain a waiver from) the terms of their ISDA or other agreements with us; or (ii) do not meet internally established guidelines regarding creditworthiness. Our ISDA and similar agreements currently require full bilateral collateralization of unrealized loss exposures with our derivative counterparties. Through a margin posting process, our positions are revalued with counterparties each business day and cash margin is generally transferred to either us or our derivative counterparties as collateral based upon the directional changes in fair value of the positions. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. With respect to certain of our derivatives, clearing and settlement is through one or more clearinghouses, which may be substituted as a counterparty. Clearing and settlement of derivative transactions through a clearinghouse is also intended to reduce specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments.

At June 30, 2014, we were in compliance with ISDA and similar agreements governing our open derivative positions. We assessed the risk associated with these counterparties as remote and did not record a specific valuation adjustment.

## Note 11. Other Assets and Liabilities

Other assets at June 30, 2014 and December 31, 2013, are summarized in the following table.

*Other Assets*

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Margin receivable | $ 58,455 | $ 31,149 |
| Investment receivable | 3,142 | 8,923 |
| Other pledged collateral | 5,000 | 5,000 |
| REO | 3,323 | 3,661 |
| Prepaid expenses | 1,576 | 1,850 |
| Fixed assets and leasehold improvements | 1,754 | 1,232 |
| Income tax receivables | 2,902 | 170 |
| Other | 1,612 | 1,655 |
| **Total Other Assets** | $ 77,764 | $ 53,640 |

Margin receivable resulted from margin calls from our swap, master repurchase agreements, and warehouse facilities counterparties that required us to post collateral.

The carrying value of REO at June 30, 2014, was $3 million, which includes the net effect of $2 million related to transfers into REO during the first six months of 2014, offset by $2 million of REO liquidations. At June 30, 2014 and December 31, 2013, there were 20 REO properties recorded on our consolidated balance sheets, all of which were owned at consolidated Sequoia entities.

*Accrued Expenses and Other Liabilities*

Accrued expenses and other liabilities at June 30, 2014 and December 31, 2013 are summarized in the following table.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Accrued compensation | $ 9,830 | $ 22,160 |
| Legal reserve | 12,000 | 12,000 |
| Derivative margin payable | 2,063 | 4,700 |
| Accrued operating expenses | 3,913 | 4,291 |
| Residential repurchase reserve | 2,477 | 1,771 |
| Income tax payable | 1,160 | 1,337 |
| Unsettled trades | 4,420 | - |
| Other | 6,360 | 2,445 |
| **Total Other Liabilities** | $ 42,223 | $ 48,704 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 11. Other Assets and Liabilities — (continued)**

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

**Note 12. Short-Term Debt**

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At June 30, 2014, we had outstanding agreements with 15 counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 – *Management's Discussion and Analysis of Financial Condition and Results of Operations* of this Quarterly Report on Form 10-Q.

The table below summarizes the facilities that are available to us and the balances of short-term debt at June 30, 2014 and December 31, 2013 by the type of collateral securing the debt.

| | June 30, 2014 | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | Number of Facilities | Outstanding | Limit | Maturity |
| **Collateral Type** | | | | |
| Residential loans | 5 | $ 852,267 | $ 1,400,000 | 7/2014-4/2015 |
| Commercial loans | 1 | 12,413 | 100,000 | 4/2015 |
| Real estate securities | 9 | 853,750 | - | 7/2014-9/2014 |
| **Total** | 15 | $ 1,718,430 | | |

| | December 31, 2013 | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | Number of Facilities | Outstanding | Limit | Maturity |
| **Collateral Type** | | | | |
| Residential loans | 5 | $ 184,789 | $ 1,400,000 | 1/2014 - 12/2014 |
| Commercial loans | 1 | - | 100,000 | 4/2014 |
| Real estate securities | 7 | 677,974 | - | 1/2014 - 2/2014 |
| **Total** | 13 | $ 862,763 | | |

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At June 30, 2014, all of these borrowings were under uncommitted facilities and were due within 364 days (or less) of the borrowing date. The fair value of residential loans, commercial loans, and real estate securities pledged as collateral was $954 million, $17 million, and $1.03 billion, respectively, at June 30, 2014. For the three and six months ended June 30, 2014, the average balance of short-term debt was $1.3 billion and $1.2 billion, respectively. At June 30, 2014 and December 31, 2013, accrued interest payable on short-term debt was $1.4 million and less than $1 million, respectively.

We also maintain a $10 million committed line of credit with one financial institution, which is secured by our pledge of certain mortgage-backed securities we own. At both June 30, 2014 and December 31, 2013, we had no outstanding borrowings on this facility.

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**Note 12. Short-Term Debt — (continued)**

***Characteristics of Short-Term Debt***

The table below summarizes short-term debt by weighted average interest rates and by collateral type at June 30, 2014 and December 31, 2013.

| | June 30, 2014 | | | December 31, 2013 | | |
|---|---|---|---|---|---|---|
| (Dollars in Thousands) | Amount Borrowed | Weighted Average Interest Rate | Weighted Average Days Until Maturity | Amount Borrowed | Weighted Average Interest Rate | Weighted Average Days Until Maturity |
| **Collateral Type** | | | | | | |
| Residential loan collateral | $ 852,267 | 1.72% | 138 | $ 184,789 | 1.71% | 228 |
| Commercial loan collateral | 12,413 | 2.40% | 300 | - | - | - |
| Real estate securities collateral | 853,750 | 1.31% | 16 | 677,974 | 1.34% | 15 |
| **Total Short-Term Debt** | $ 1,718,430 | 1.52% | 78 | $ 862,763 | 1.42% | 61 |

***Remaining Maturities of Short-Term Debt***

The following table presents the remaining maturities of short-term debt at June 30, 2014 and December 31, 2013.

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Within 30 days | $ 1,069,160 | $ 659,262 |
| 31 to 90 days | 186,227 | 54,434 |
| Over 90 days | 463,043 | 149,067 |
| **Total Short-Term Debt** | $ 1,718,430 | $ 862,763 |

**Note 13. Asset-Backed Securities Issued**

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

The carrying values of ABS issued by consolidated securitization entities we sponsored at June 30, 2014 and December 31, 2013, along with other selected information, are summarized in the following table.

***Asset-Backed Securities Issued***

| | June 30, 2014 | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | Sequoia | Residential Resecuritization | Commercial Securitization | Total |
| Certificates with principal balance | $ 1,565,943 | $ 69,709 | $ 144,700 | $ 1,780,352 |
| Interest-only certificates | 2,605 | - | - | 2,605 |
| Unamortized discount | (14,879) | - | - | (14,879) |
| **Total ABS Issued** | $ 1,553,669 | $ 69,709 | $ 144,700 | $ 1,768,078 |
| Range of weighted average interest rates, by series | 0.11% to 4.25% | 2.21% | 5.62% | |
| Stated maturities | 2014 -2047 | 2046 | 2018 | |
| Number of series | 24 | 1 | 1 | |

| | December 31, 2013 | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | Sequoia | Residential Resecuritization | Commercial Securitization | Total |
| Certificates with principal balance | $ 1,708,324 | $ 94,934 | $ 153,693 | $ 1,956,951 |
| Interest-only certificates | 3,400 | - | - | 3,400 |
| Unamortized discount | (17,389) | - | - | (17,389) |
| **Total ABS Issued** | $ 1,694,335 | $ 94,934 | $ 153,693 | $ 1,942,962 |
| Range of weighted average interest rates, by series | 0.24% to 4.23% | 2.21% | 5.62% | |
| Stated maturities | 2014 - 2047 | 2046 | 2018 | |
| Number of series | 24 | 1 | 1 | |

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its contractual maturity. At June 30, 2014, $1.75 billion of ABS issued ($1.76 billion principal balance) had contractual maturities beyond five years and $19 million of ABS issued ($19 million principal balance) had contractual maturities of less than one year. Amortization of Sequoia, Commercial Securitization, and Residential Resecuritization deferred ABS issuance costs was $1 million and $2 million for the six months ended June 30, 2014 and 2013, respectively. The following table summarizes the accrued interest payable on ABS issued at June 30, 2014 and December 31, 2013. Interest due on consolidated ABS issued is payable monthly.

***Accrued Interest Payable on Asset-Backed Securities Issued***

| (In Thousands) | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Sequoia | $ 1,078 | $ 1,218 |
| Residential Resecuritization | 17 | 11 |
| Commercial Securitization | 678 | 720 |
| **Total Accrued Interest Payable on ABS Issued** | $ 1,773 | $ 1,949 |

REDWOOD TRUST, INC. AND SUBSIDIARIES

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

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at June 30, 2014 and December 31, 2013.

***Collateral for Asset-Backed Securities Issued***

| | June 30, 2014 | | | |
|---|---|---|---|---|
| (In Thousands) | Sequoia | Residential Resecuritization | Commercial Securitization | Total |
| Residential loans | $ 1,616,504 | $ - | $ - | $ 1,616,504 |
| Commercial loans | - | - | 254,615 | 254,615 |
| Real estate securities | - | 245,853 | - | 245,853 |
| Restricted cash | 145 | - | 138 | 283 |
| Accrued interest receivable | 2,391 | 549 | 1,826 | 4,766 |
| REO | 3,323 | - | - | 3,323 |
| **Total Collateral for ABS Issued** | $ 1,622,363 | $ 246,402 | $ 256,579 | $ 2,125,344 |

| | December 31, 2013 | | | |
|---|---|---|---|---|
| (In Thousands) | Sequoia | Residential Resecuritization | Commercial Securitization | Total |
| Residential loans | $ 1,762,167 | $ - | $ - | $ 1,762,167 |
| Commercial loans | - | - | 257,741 | 257,741 |
| Real estate securities | - | 263,204 | - | 263,204 |
| Restricted cash | 152 | - | 137 | 289 |
| Accrued interest receivable | 2,714 | 627 | 1,975 | 5,316 |
| REO | 3,661 | - | - | 3,661 |
| **Total Collateral for ABS Issued** | $ 1,768,694 | $ 263,831 | $ 259,853 | $ 2,292,378 |

**Note 14. Long-Term Debt**

***Commercial Borrowings***

At June 30, 2014, we had one commercial loan repurchase facility with an outstanding balance of $53 million and a total borrowing limit of $150 million, with a remaining maturity of 15 months. Borrowings under this facility are generally charged interest based on a specified margin over the one-month LIBOR interest rate. For both the three and six months ended June 30, 2014, the average balance of this commercial borrowing was $51 million. The fair value of commercial loans pledged as collateral was $85 million at June 30, 2014. The interest expense yield on this borrowing was 5.45% for the six months ended June 30, 2014. At December 31, 2013, there was an outstanding balance of $49 million on this warehouse facility.

At June 30, 2014, we were in compliance with all of the covenants related to our commercial loan repurchase facility.

***Commercial Secured Borrowing***

At June 30, 2014, we had commercial secured borrowings of $67 million resulting from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. We bifurcated certain of our senior commercial mortgage loans into a senior portion that was sold to a third party and a junior portion that we retained as an investment. Although GAAP requires us to record a secured borrowing liability when we receive cash from selling the senior portion of the loan, the liability has no economic substance to us in that it does not require periodic interest payments and has no maturity. For each commercial secured borrowing, at such time that the associated senior portion of the loan is repaid or we sell our retained junior portion, the secured borrowing liability and associated senior portion of the loan would be derecognized from our balance sheet.

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**Note 14. Long-Term Debt — (continued)**

***Convertible Notes***

In March 2013, we issued $287.5 million principal amount of 4.625% convertible senior notes due 2018. These convertible notes require semi-annual interest distributions at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. Including amortization of deferred securities issuance costs, the interest expense yield on our convertible notes was 5.44% and 5.42% for the three and six months ended June 30, 2014, respectively. At June 30, 2014, the accrued interest payable balance on this debt was $3 million.

At June 30, 2014, our convertible senior notes were convertible at the option of the holder at a conversion rate of 41.1320 common shares per $1,000 principal amount of convertible senior notes (equivalent to a conversion price of $24.31 per common share). Upon conversion of these convertible senior notes by a holder, the holder will receive shares of our common stock.

***Trust Preferred Securities and Subordinated Notes***

At June 30, 2014, we had trust preferred securities and subordinated notes outstanding of $100 million and $40 million, respectively. The interest expense yield on both our trust preferred securities and subordinated notes was 2.55% and 2.65% for the six months ended June 30, 2014 and 2013, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on both our trust preferred securities and subordinated notes was 6.87% and 6.89% for the six months ended June 30, 2014 and 2013, respectively.

At both June 30, 2014 and December 31, 2013, the accrued interest payable balance on our trust preferred securities and subordinated notes was less than $1 million. Under the terms of this long-term debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this long-term debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is *pari passu* or subordinate to this long-term debt.

**Note 15. Commitments and Contingencies**

***Lease Commitments***

At June 30, 2014, we were obligated under seven non-cancelable operating leases with expiration dates through 2021 for $14 million. Operating lease expense was $1 million and less than $1 million for the six months ended June 30, 2014 and 2013, respectively.

The following table presents our future lease commitments at June 30, 2014.

***Future Lease Commitments by Year***

| (In Thousands) | June 30, 2014 |
|---|---|
| 2014 (6 months) | $ 1,470 |
| 2015 | 2,997 |
| 2016 | 2,766 |
| 2017 | 2,811 |
| 2018 | 1,756 |
| 2019 and thereafter | 2,611 |
| **Total** | $ 14,411 |

***Loss Contingencies — Residential Repurchase Reserve***

We maintain a repurchase reserve for potential obligations arising from representation and warranty violations related to the residential loans we have sold to securitization trusts or third parties. We do not originate residential loans and we believe the initial risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the

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**Note 15. Commitments and Contingencies — (continued)**

companies from whom we acquired the loans. However, in some cases, for example, where loans were acquired from companies that have since become insolvent, repurchase claims may result in our being liable for a repurchase obligation.

At June 30, 2014, our repurchase reserve associated with our residential loans was $2.5 million. This liability is recorded in accrued expenses and other liabilities in our consolidated balance sheets and the provision for repurchase losses is included in mortgage banking activities, net in our consolidated statements of income. We did not receive any repurchase requests for either of the six months ended June, 2014 and 2013, and we did not repurchase any loans during those periods.

***Loss Contingencies — Litigation***

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the “FHLB-Seattle”) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (“SRF”), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the “FHLB-Seattle Defendants”) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Seattle Certificate”) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the “2005-4 RMBS”) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys’ fees and costs. The Seattle Certificate was issued with an original principal amount of approximately $133 million, and, as of June 30, 2014, the FHLB-Seattle has received approximately $115.3 million of principal and $11.0 million of interest payments in respect of the Seattle Certificate. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle’s claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (“Schwab”) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the “Schwab Defendants”) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Schwab Certificate”) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. Schwab alleges a claim for negligent misrepresentation under California state law and seeks unspecified damages and attorneys’ fees and costs. The Schwab Certificate was issued with an original principal amount of approximately $14.8 million, and, as of June 30, 2014, Schwab has received approximately $12.8 million of principal and $1.3 million of interest payments in respect of the Schwab Certificate. SRF has denied Schwab’s allegations. This case is in discovery, and no trial date has been set. We intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named as defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about October 15, 2010, the Federal Home Loan Bank of Chicago (“FHLB-Chicago”) filed a complaint in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the “FHLB-Chicago Defendants”) alleging that the FHLB-Chicago Defendants made false or misleading statements in offering materials for various RMBS sold or issued by the FHLB-Chicago Defendants or entities controlled by them. FHLB-Chicago subsequently amended the complaint to name Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc., as defendants. With respect to Redwood Trust, Inc., RWT Holdings, Inc., and SRF, the FHLB-Chicago alleges that SRF, Redwood Trust, Inc., and RWT Holdings, Inc. made false or misleading statements in the offering materials for two mortgage pass-through certificates (the “Chicago

**Note 15. Commitments and Contingencies — (continued)**

Certificates") issued in the Sequoia Mortgage Trust 2006-1 securitization transaction (the "2006-1 RMBS") and purchased by the FHLB-Chicago. The complaint alleges that the alleged misstatements concern, among other things, the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2006-1 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, (4) ratings assigned to the Chicago Certificates, and (5) due diligence performed on these mortgage loans. The FHLB-Chicago alleges claims under Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law (N.C.G.S.A. §78A-8(2) & §78A-56(a)) as well as a claim for negligent misrepresentation under Illinois common law. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of the Chicago Certificates and to collect interest on the original purchase prices at the statutory interest rate of 10% per annum from the dates of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys' fees and costs. The first of the Chicago Certificates was issued with an original principal amount of approximately $105 million and, as of June 30, 2014, the FHLB Chicago has received approximately $73.6 million of principal and $24.6 million of interest payments in respect of this Chicago Certificate. The second of the Chicago Certificates was issued with an original principal amount of approximately $379 million and, as of June 30, 2014, the FHLB Chicago has received approximately $263.7 million of principal and $83.0 million of interest payments in respect of this Chicago Certificate. SRF, Redwood Trust, Inc., and RWT Holdings, Inc. have denied FHLB-Chicago's allegations. This case is in discovery, and no trial date has been set. Redwood agreed to indemnify the underwriters of the 2006-1 RMBS, which underwriters were also named as defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At June 30, 2014, the aggregate amount of loss contingency reserves established in respect of the three above-referenced litigation matters was $12 million. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

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

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

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(Unaudited)

**Note 16. Equity**

The following table provides a summary of changes to accumulated other comprehensive income by component for the three and six months ended June 30, 2014 and 2013.

***Changes in Accumulated Other Comprehensive Income by Component***

| | Three Months Ended June 30, 2014 | | Three Months Ended June 30, 2013 | |
|---|---|---|---|---|
| **(In Thousands)** | **Net unrealized gains on available-for-sale securities** | **Net unrealized losses on interest rate agreements accounted for as cash flow hedges** | **Net unrealized gains on available-for-sale securities** | **Net unrealized losses on interest rate agreements accounted for as cash flow hedges** |
| Balance at beginning of period | $ 185,275 | $ (24,623) | $ 183,603 | $ (40,720) |
| Other comprehensive income (loss) before reclassifications | 12,721 | (5,401) | (38,012) | 13,585 |
| Amounts reclassified from other accumulated comprehensive income | (454) | 39 | (242) | 69 |
| Net current-period other comprehensive (loss) income | 12,267 | (5,362) | (38,254) | 13,654 |
| **Balance at End of Period** | $ 197,542 | $ (29,985) | $ 145,349 | $ (27,066) |

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**Note 16. Equity — (continued)**

| (In Thousands) | Six Months Ended June 30, 2014 | | Six Months Ended June 30, 2013 | |
|---|---|---|---|---|
| | Net unrealized gains on available-for-sale securities | Net unrealized losses on interest rate agreements accounted for as cash flow hedges | Net unrealized gains on available-for-sale securities | Net unrealized losses on interest rate agreements accounted for as cash flow hedges |
| Balance at beginning of period | $ 164,654 | $ (15,888) | $ 186,580 | $ (48,248) |
| Other comprehensive income (loss) before reclassifications | 33,229 | (14,196) | (28,982) | 21,025 |
| Amounts reclassified from other accumulated comprehensive income | (341) | 99 | (12,249) | 157 |
| Net current-period other comprehensive (loss) income | 32,888 | (14,097) | (41,231) | 21,182 |
| **Balance at End of Period** | $ 197,542 | $ (29,985) | $ 145,349 | $ (27,066) |

The following table provides a summary of reclassifications out of accumulated other comprehensive income for three and six months ended June 30, 2014 and 2013.

***Reclassifications Out of Accumulated Other Comprehensive Income***

| (In Thousands) | Affected Line Item in the Income Statement | Amount reclassified from accumulated other comprehensive income Three Months Ended June 30, 2014 | 2013 |
|---|---|---|---|
| **Net realized gains (losses) on AFS securities** | | | |
| Other than temporary impairment | Other market valuations, net | $ 264 | $ (133) |
| Gain on sale of AFS securities | Realized gains, net | (718) | (109) |
| | | $ (454) | $ (242) |
| **Net realized gains on interest rate agreements designated as cash flow hedges** | | | |
| Amortization of deferred loss | Interest expense | $ 39 | $ 69 |
| | | $ 39 | $ 69 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 16. Equity — (continued)**

| (In Thousands) | Affected Line Item in the Income Statement | Amount reclassified from accumulated other comprehensive income Six Months Ended June 30, 2014 | 2013 |
|---|---|---|---|
| **Net realized gains (losses) on AFS securities** | | | |
| Other than temporary impairment | Other market valuations, net | $ 377 | $ (124) |
| Gain on sale of AFS securities | Realized gains, net | (718) | (12,125) |
| | | $ (341) | $ (12,249) |
| **Net realized gains on interest rate agreements designated as cash flow hedges** | | | |
| Amortization of deferred loss | Interest expense | $ 99 | $ 157 |
| | | $ 99 | $ 157 |

***Earnings Per Common Share***

The following table provides the basic and diluted earnings per common share computations for the three and six months ended June 30, 2014 and 2013.

***Basic and Diluted Earnings Per Common Share***

| (In Thousands, Except Share Data) | Three Months Ended June 30, 2014 | 2013 | Six Months Ended June 30, 2014 | 2013 |
|---|---|---|---|---|
| **Basic Earnings Per Common Share:** | | | | |
| Net income attributable to Redwood | $ 16,017 | $ 65,573 | $ 28,350 | $ 126,183 |
| Less: Dividends and undistributed earnings allocated to participating securities | (537) | (1,830) | (1,239) | (3,819) |
| Net income allocated to common shareholders | $ 15,480 | $ 63,743 | $ 27,111 | $ 122,364 |
| Basic weighted average common shares outstanding | 82,740,012 | 82,123,823 | 82,575,636 | 81,729,014 |
| **Basic Earnings Per Common Share** | $ 0.19 | $ 0.78 | $ 0.33 | $ 1.50 |
| **Diluted Earnings Per Common Share:** | | | | |
| Net income attributable to Redwood | $ 16,017 | $ 65,573 | $ 28,350 | $ 126,183 |
| Less: Dividends and undistributed earnings allocated to participating securities | (537) | (1,175) | (1,239) | (2,527) |
| Add back: Interest expense on convertible notes | - | 3,856 | - | 4,933 |
| Net income allocated to common shareholders | $ 15,480 | $ 68,254 | $ 27,111 | $ 128,589 |
| Weighted average common shares outstanding | 82,740,012 | 82,123,823 | 82,575,636 | 81,729,014 |
| Net effect of dilutive equity awards | 2,292,986 | 2,222,440 | 2,418,685 | 2,274,311 |
| Net effect of assumed convertible notes conversion to common shares | - | 11,825,450 | - | 7,644,075 |
| Diluted weighted average common shares outstanding | 85,032,998 | 96,171,713 | 84,994,321 | 91,647,400 |
| **Diluted Earnings Per Common Share** | $ 0.18 | $ 0.71 | $ 0.32 | $ 1.40 |

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

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**Note 16. Equity — (continued)**

For the three and six months ended June 30, 2014, there were 2,292,986 and 2,418,685 of dilutive equity awards, respectively, determined under the two-class method. For the three and six months ended June 30, 2013, there were 2,222,440 and 2,274,311 of dilutive equity awards, respectively, determined under the two-class method. We included participating securities in the calculation of diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances. For the three and six months ended June 30, 2013, common shares related to the assumed conversion of the convertible notes, totaling 11,825,450 and 7,644,075, respectively, were included in the calculation of diluted earnings per share.

For the three and six months ended June 30, 2014, 11,825,450 common shares related to the assumed conversion of the convertible notes were antidilutive and were excluded in the calculation of diluted earnings per share. For the three months ended June 30, 2014 and 2013, the number of outstanding equity awards that were antidilutive totaled 61,580 and 255,529 respectively, under the two-class method. For the six months ended June 30, 2014 and 2013, the number of outstanding equity awards that were antidilutive totaled 70,508 and 271,392 respectively, under the two-class method. There were no other participating securities during these periods.

***Stock Repurchases***

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the six months ended June 30, 2014, there were no shares acquired under the plan. At June 30, 2014, there remained 4,005,985 shares available for repurchase under this plan.

**Note 17. Equity Compensation Plans**

At June 30, 2014 and December 31, 2013, 2,608,264 and 1,683,956 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled $17 million at June 30, 2014, as shown in the following table.

| | Six Months Ended June 30, 2014 | | | | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Stock Options | Restricted Stock | Deferred Stock Units | Performance Stock Units | Employee Stock Purchase Plan | Total |
| Unrecognized compensation cost at beginning of period | $ - | $ 1,869 | $ 13,044 | 5,817 | - | 20,730 |
| Equity grants | - | 30 | 1,128 | - | 215 | 1,373 |
| Equity grant forfeitures | - | (154) | (150) | - | - | (304) |
| Equity compensation expense | - | (349) | (3,234) | (1,464) | (107) | (5,154) |
| **Unrecognized Compensation Cost at End of Period** | $ - | $ 1,396 | $ 10,788 | $ 4,353 | $ 108 | $ 16,645 |

At June 30, 2014, the weighted average amortization period remaining for all of our equity awards was less than two years.

***Stock Options***

At June 30, 2014 and December 31, 2013, there were 57,514 and 79,535 fully vested stock options outstanding, respectively. There was no aggregate intrinsic value for the options outstanding and exercisable at June 30, 2014. For both the six months ended June 30, 2014 and 2013, there were no stock options exercised. For the six months ended June 30, 2014, 22,021 stock options expired.

***Restricted Stock***

At June 30, 2014 and December 31, 2013, there were 112,418 and 166,941 shares, respectively, of restricted stock awards outstanding. Restrictions on these shares lapse through 2018. There were no restricted stock awards granted during the six months ended June 30 2014.

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**Note 17. Equity Compensation Plans — (continued)**

***Deferred Stock Units ("DSUs")***

At June 30, 2014 and December 31, 2013, there were 2,033,771 and 2,266,473 DSUs outstanding, respectively, of which 1,224,122 and 1,263,420, respectively, had vested. There were 139,147 DSUs granted during the six months ended June 30, 2014. During the six months ended June 30, 2014, there were 7,870 DSUs forfeited related to employee departures. During the six months ended June 30, 2014, there were 363,980 DSU distributions and cash distributions of less than $1 million to participants in the EDCP. Unvested DSUs at June 30, 2014 vest through 2018.

***Performance Stock Units ("PSUs")***

At both June 30, 2014 and December 31, 2013, the target number of PSUs that were unvested was 779,871. PSUs do not vest until the third anniversary of their grant date, with the level of vesting at that time contingent on total stockholder return (defined as the change in our common stock price plus dividends paid on our common stock relative to the per share price of our common stock on the date of the PSU grant) over the three-year vesting period ("Three-Year TSR"). The number of underlying shares of our common stock that will vest during 2014 and in future years will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the target number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period. During the six months ended June 30, 2014, 351,640 shares of common stock underlying vested PSUs were distributed.

***Employee Stock Purchase Plan***

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. At June 30, 2014 and December 31, 2013, 257,921 and 243,020 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

**Note 18. Mortgage Banking Activities**

The following table presents the components of mortgage banking activities, net, recorded in our consolidated income statements for the three and six months ended June 30, 2014 and 2013.

***Components of Mortgage Banking Activities, Net***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| **Residential mortgage banking activities:** | | | | |
| Changes in fair value of: | | | | |
| Residential loans, at fair value | $ 13,375 | $ (41,405) | $ 20,403 | $ (6,535) |
| Sequoia IO securities | (8,810) | 36,336 | (13,087) | 38,265 |
| Risk management derivatives (1) | (7,858) | 46,621 | (12,136) | 48,508 |
| Loan purchase and forward sale commitments | 3,582 | - | 3,590 | - |
| Other fees | 1,040 | 738 | 1,495 | 1,276 |
| Total residential mortgage banking activities: | 1,329 | 42,290 | 265 | 81,514 |
| **Commercial mortgage banking activities:** | | | | |
| Changes in fair value of: | | | | |
| Commercial loans, at fair value | 5,714 | (345) | 9,340 | (345) |
| Risk management derivatives (1) | (815) | 2,924 | (3,619) | 2,059 |
| Other fees | 82 | - | 93 | 1 |
| Net gains on commercial loan originations and sales | - | 3,854 | - | 11,031 |
| Total commercial mortgage banking activities: | 4,981 | 6,433 | 5,814 | 12,746 |
| **Mortgage Banking Activities, Net** | $ 6,310 | $ 48,723 | $ 6,079 | $ 94,260 |

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

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2014**
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**Note 19. Operating Expenses**

Components of our operating expenses for the three and six months ended June 30, 2014 and 2013 are presented in the following table.

***Operating Expenses***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Fixed compensation expense | $ 6,872 | $ 6,080 | $ 13,664 | $ 11,716 |
| Variable compensation expense | 3,021 | 3,960 | 5,752 | 8,797 |
| Equity compensation expense | 2,824 | 3,396 | 5,154 | 5,883 |
| Severance expense | 222 | 3,366 | 222 | 3,434 |
| Total compensation expense | 12,939 | 16,802 | 24,792 | 29,830 |
| Systems and consulting | 3,977 | 2,318 | 7,443 | 4,060 |
| Accounting and legal | 1,183 | 805 | 2,816 | 3,052 |
| Office costs | 1,170 | 827 | 2,155 | 1,615 |
| Corporate costs | 558 | 528 | 1,111 | 1,037 |
| Other operating expenses | 2,455 | 3,150 | 3,937 | 5,022 |
| **Total Operating Expenses** | $ 22,282 | $ 24,430 | $ 42,254 | $ 44,616 |

**Note 20. Taxes**

For the six months ended June 30, 2014 and 2013, we recognized a benefit for income taxes of $2 million and a provision of $14 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at June 30, 2014 and 2013.

***Reconciliation of Statutory Tax Rate to Effective Tax Rate***

| | **June 30, 2014** | **June 30, 2013** |
|---|---|---|
| Federal statutory rate | 34.0 % | 34.0 % |
| State statutory rate, net of Federal tax effect | 7.2 % | 7.2 % |
| Differences in taxable (loss) income from GAAP income | (2.5) % | (8.3) % |
| Change in valuation allowance | 1.2 % | (12.2) % |
| Dividends paid deduction | (45.5) % | (10.7) % |
| **Effective Tax Rate** | (5.6) % | 10.0 % |

The negative effective tax rate for the six months ended June 30, 2014, primarily resulted from a benefit from income taxes recorded against a GAAP loss generated at our taxable REIT subsidiaries, while GAAP income generated at the REIT, for which no material tax provision was recorded due to the dividends paid deduction available to us, exceeded the loss at the taxable REIT subsidiaries.

We assessed our tax positions for all open tax years (Federal — years 2010 to 2014, State — years 2009 to 2014) and, at June 30, 2014 and December 31, 2013, concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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**Note 21. Segment Information**

Redwood operates in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. These business segments have been identified based on our organizational and management structure. Our segments are based on an internally-aligned segment structure, which is how our results are monitored and performance is assessed. The accounting policies of the reportable segments are the same as those described in *Note 3*—Summary of Significant Accounting Policies.

Our residential mortgage banking segment primarily consists of operating a mortgage loan conduit that acquires residential loans from third-party originators for subsequent sale through securitization or as whole loans. Jumbo loans we acquire are typically sold through private-label securitization through our Sequoia securitization program or to institutions that acquire pools of whole loans. Conforming loans we acquire are generally sold to the Agencies. Our residential loan acquisitions are usually made on a flow basis, after origination by banks or mortgage companies, and are periodically augmented by bulk acquisitions. Our acquisition and accumulation of residential loans is generally funded with equity and short-term debt. This segment also includes various derivative financial instruments and IO securities retained from our Sequoia securitizations that we utilize to manage certain risks associated with residential loans we acquire. Our residential mortgage banking segment's main source of revenue is mortgage banking income, which includes valuation increases (or gains) on the loans we acquire for sale or securitization as well as valuation changes in associated derivatives and IO securities that are used in part to manage risks associated with our mortgage banking activities. Additionally, this segment may generate interest income on loans held for future sale or securitization and interest income from IO securities. Interest expense on short-term debt used to fund the purchase of residential loans, direct operating expenses and tax provisions associated with these activities are also included in the residential mortgage banking segment.

Our residential investments segment includes a portfolio of investments in residential mortgage-backed securities retained from our Sequoia securitizations, as well as residential mortgage-backed securities issued by third parties. This segment also includes MSRs associated with residential loans securitized through our Sequoia program and MSRs purchased from third parties. The residential investment segment's main sources of revenue are interest income from investment portfolio securities, as well as the realized gains recognized upon sales of these securities and income from MSRs. This segment also includes derivative financial instruments that we utilize to manage certain risks associated with our residential investment portfolio. Also included in this segment is interest expense on the short-term debt and ABS used to partially finance certain of these securities, as well as direct operating expenses and tax provisions associated with these activities.

Our commercial mortgage banking and investments segment consists of our commercial mortgage banking operations as well as our portfolio of held-for-investment commercial real estate loans. We operate as a commercial real estate lender by originating mortgage loans and providing other forms of commercial real estate financing. This may include senior or subordinate mortgage loans, mezzanine loans, and other forms of financing, such as preferred equity interests in special purpose entities that own commercial real estate. We typically sell the senior loans we originate to third parties for securitization and the mezzanine and subordinate loans we originate are generally held for investment. This segment also includes derivative financial instruments that we utilize to manage certain risks associated with our commercial loan origination activity. Our commercial mortgage banking and investments segment's main sources of revenue are interest income from our commercial loan investments as well as income from mortgage banking activities, which includes valuation increases (or gains) on the senior commercial loans we originate for sale as well as valuation changes in associated derivatives that are used to manage risks associated with our mortgage banking activities. Interest expense from our Commercial Securitization and from short-term and long-term debt used to fund the purchase of commercial loans as well as operating expenses and tax provisions associated with these activities are also included in the commercial mortgage banking and investments segment.

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

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**Note 21. Segment Information — (continued)**

The following tables present financial information by segment for the three and six months ended June 30, 2014 and 2013.

***Business Segment Financial Information***

| | Three Months Ended June 30, 2014 | | | | |
|---|---|---|---|---|---|
| (In Thousands) | Residential Mortgage Banking | Residential Investments | Commercial Mortgage Banking and Investments | Corporate/ Other | Total |
| Interest income | $ 12,438 | $ 27,924 | $ 11,217 | $ 6,414 | $ 57,993 |
| Interest expense | (2,161) | (3,116) | (4,404) | (11,470) | (21,151) |
| **Net interest income (loss)** | 10,277 | 24,808 | 6,813 | (5,056) | 36,842 |
| Reversal of provision (provision) for loan losses | - | - | (289) | 604 | 315 |
| Mortgage banking activities, net | 1,329 | - | 4,981 | - | 6,310 |
| MSR income (loss), net | - | (1,777) | - | - | (1,777) |
| Other market valuation adjustments, net | 13 | (3,788) | - | (346) | (4,121) |
| Realized gains, net | - | 992 | - | 71 | 1,063 |
| Operating expenses | (9,501) | (770) | (2,180) | (9,831) | (22,282) |
| (Provision for) benefit from income taxes | 259 | 149 | (750) | 9 | (333) |
| Segment Contribution | $ 2,377 | $ 19,614 | $ 8,575 | $ (14,549) | |
| **Net Income** | | | | | $ 16,017 |
| Non-cash amortization income (expense) | (36) | 10,586 | (215) | (2,073) | 8,262 |

| | Three Months Ended June 30, 2013 | | | | |
|---|---|---|---|---|---|
| (In Thousands) | Residential Mortgage Banking | Residential Investments | Commercial Mortgage Banking and Investments | Corporate/ Other | Total |
| Interest income | $ 15,158 | $ 24,015 | $ 9,623 | $ 8,923 | $ 57,719 |
| Interest expense | (3,020) | (2,553) | (2,560) | (13,283) | (21,416) |
| **Net interest income (loss)** | 12,138 | 21,462 | 7,063 | (4,360) | 36,303 |
| Reversal of provision (provision) for loan losses | - | - | (891) | 4,163 | 3,272 |
| Mortgage banking activities, net | 42,290 | - | 6,433 | - | 48,723 |
| MSR income (loss), net | - | 10,547 | - | - | 10,547 |
| Other market valuation adjustments, net | 38 | (5,738) | - | (558) | (6,258) |
| Realized gains, net | - | 526 | - | 30 | 556 |
| Operating expenses | (6,053) | (1,956) | (2,654) | (13,767) | (24,430) |
| (Provision for) benefit from income taxes | (2,409) | (1,236) | (495) | 1,000 | (3,140) |
| Segment Contribution | $ 46,004 | $ 23,605 | $ 9,456 | $ (13,492) | |
| **Net Income** | | | | | $ 65,573 |
| Non-cash amortization income (expense) | (13) | 8,066 | (224) | (2,084) | 5,745 |

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**Note 21. Segment Information — (continued)**

| | Six Months Ended June 30, 2014 | | | | |
|---|---|---|---|---|---|
| **(In Thousands)** | **Residential Mortgage Banking** | **Residential Investments** | **Commercial Mortgage Banking and Investments** | **Corporate/ Other** | **Total** |
| Interest income | $ 23,104 | $ 55,519 | $ 21,601 | $ 13,245 | $ 113,469 |
| Interest expense | (3,482) | (5,966) | (7,708) | (23,055) | (40,211) |
| **Net interest income (loss)** | 19,622 | 49,553 | 13,893 | (9,810) | 73,258 |
| Provision for loan losses | - | - | (944) | (23) | (967) |
| Mortgage banking activities, net | 265 | - | 5,814 | - | 6,079 |
| MSR income (loss), net | - | (1,171) | - | - | (1,171) |
| Other market valuation adjustments, net | 11 | (9,746) | - | (525) | (10,260) |
| Realized gains, net | - | 1,979 | - | 176 | 2,155 |
| Operating expenses | (16,595) | (1,865) | (4,806) | (18,988) | (42,254) |
| (Provision for) benefit from income taxes | 94 | 1,676 | (395) | 135 | 1,510 |
| Segment Contribution | $ 3,397 | $ 40,426 | $ 13,562 | $ (29,035) | |
| **Net Income** | | | | | $ 28,350 |
| Non-cash amortization income (expense) | (88) | 21,833 | (388) | (4,019) | 17,338 |

| | Six Months Ended June 30, 2013 | | | | |
|---|---|---|---|---|---|
| **(In Thousands)** | **Residential Mortgage Banking** | **Residential Investments** | **Commercial Mortgage Banking and Investments** | **Corporate/ Other** | **Total** |
| Interest income | $ 24,914 | $ 47,533 | $ 19,794 | $ 19,002 | $ 111,243 |
| Interest expense | (5,130) | (5,219) | (5,368) | (24,001) | (39,718) |
| **Net interest income (loss)** | 19,784 | 42,314 | 14,426 | (4,999) | 71,525 |
| Reversal of provision (provision) for loan losses | - | - | (1,576) | 2,809 | 1,233 |
| Mortgage banking activities, net | 81,514 | - | 12,746 | - | 94,260 |
| MSR income (loss), net | - | 11,568 | - | - | 11,568 |
| Other market valuation adjustments, net | 78 | (6,308) | - | (331) | (6,561) |
| Realized gains, net | - | 12,564 | 210 | 49 | 12,823 |
| Operating expenses | (10,691) | (3,539) | (5,850) | (24,536) | (44,616) |
| (Provision for) benefit from income taxes | (11,314) | (1,661) | (1,718) | 644 | (14,049) |
| Segment Contribution | $ 79,371 | $ 54,938 | $ 18,238 | $ (26,364) | |
| **Net Income** | | | | | $ 126,183 |
| Non-cash amortization income (expense) | (119) | 15,646 | (411) | (3,381) | 11,735 |

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2014
(Unaudited)

**Note 21. Segment Information — (continued)**

The following tables present the components of Corporate/Other for the three and six months ended June 30, 2014 and 2013.

| | Three Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2014 | | | 2013 | | |
| (In Thousands) | Legacy Consolidated VIEs | Other | Total | Legacy Consolidated VIEs | Other | Total |
| Interest income | $ 6,411 | $ 3 | $ 6,414 | $ 8,786 | $ 137 | $ 8,923 |
| Interest expense | (5,240) | (6,230) | (11,470) | (6,728) | (6,555) | (13,283) |
| **Net interest income (loss)** | 1,171 | (6,227) | (5,056) | 2,058 | (6,418) | (4,360) |
| Reversal of provision for loan losses | 604 | - | 604 | 4,163 | - | 4,163 |
| Mortgage banking activities, net | - | - | - | - | - | - |
| MSR income, net | - | - | - | - | - | - |
| Other market valuation adjustments, net | (321) | (25) | (346) | (558) | - | (558) |
| Realized gains, net | 71 | - | 71 | 30 | - | 30 |
| Operating expenses | (42) | (9,789) | (9,831) | (73) | (13,694) | (13,767) |
| Benefit from income taxes | - | 9 | 9 | - | 1,000 | 1,000 |
| **Total** | $ 1,483 | $(16,032) | $ (14,549) | $ 5,620 | $(19,111) | $ (13,492) |
| Non-cash amortization expense | (1,432) | (641) | (2,073) | (1,561) | (523) | (2,084) |

| | Six Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2014 | | | 2013 | | |
| (In Thousands) | Legacy Consolidated VIEs | Other | Total | Legacy Consolidated VIEs | Other | Total |
| Interest income | $ 13,240 | $ 5 | $ 13,245 | $ 18,853 | $ 149 | $ 19,002 |
| Interest expense | (10,699) | (12,356) | (23,055) | (13,997) | (10,004) | (24,001) |
| **Net interest income (loss)** | 2,541 | (12,351) | (9,810) | 4,856 | (9,855) | (4,999) |
| Reversal of provision (provision) for loan losses | (23) | - | (23) | 2,809 | - | 2,809 |
| Mortgage banking activities, net | - | - | - | - | - | - |
| MSR income), net | - | - | - | - | - | - |
| Other market valuation adjustments, net | (464) | (61) | (525) | (331) | - | (331) |
| Realized gains, net | 176 | - | 176 | 49 | - | 49 |
| Operating expenses | (94) | (18,894) | (18,988) | (107) | (24,429) | (24,536) |
| Benefit from income taxes | - | 135 | 135 | - | 644 | 644 |
| **Total** | $ 2,136 | $(31,171) | $ (29,035) | $ 7,276 | $(33,640) | $ (26,364) |
| Non-cash amortization expense | (2,795) | (1,224) | (4,019) | (2,664) | (717) | (3,381) |

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2014
(Unaudited)

**Note 21. Segment Information — (continued)**

The following table presents supplemental information by segment at June 30, 2014 and December 31, 2013.

***Supplemental Disclosures***

| (In Thousands) | Residential Mortgage Banking | Residential Investments | Commercial Mortgage Banking and Investments | Corporate/ Other | Total |
|---|---|---|---|---|---|
| **June 30, 2014** | | | | | |
| Residential loans, held-for-sale | $ 1,107,877 | $ - | $ - | $ - | $ 1,107,877 |
| Residential loans, held-for-investment | - | - | - | 1,616,504 | 1,616,504 |
| Commercial loans | - | - | 468,766 | - | 468,766 |
| Real estate securities | 159,311 | 1,685,756 | - | - | 1,845,067 |
| Mortgage servicing rights | - | 71,225 | - | - | 71,225 |
| Total assets | 1,291,983 | 1,774,525 | 474,821 | 1,837,221 | 5,378,550 |
| | | | | | |
| **December 31, 2013** | | | | | |
| Residential loans, held-for-sale | $ 404,267 | $ - | $ - | $ - | $ 404,267 |
| Residential loans, held-for-investment | - | - | - | 1,762,167 | 1,762,167 |
| Commercial loans | - | - | 432,455 | - | 432,455 |
| Real estate securities | 110,505 | 1,572,356 | - | - | 1,682,861 |
| Mortgage servicing rights | - | 64,824 | - | - | 64,824 |
| Total assets | 531,092 | 1,655,209 | 439,139 | 1,983,088 | 4,608,528 |

**Note 22. Subsequent Events**

At June 30, 2014, we had identified for purchase $1.6 billion of jumbo residential mortgage loans that were in various stages of the origination process with third-party originators. Some of these loans may not ultimately close and, therefore, would not be available for purchase. Since June 30, 2014, and through August 3, 2014, $643 million of these loans closed and were purchased by us. We expect the purchase of an additional amount of these loans to occur during the third quarter of 2014, subject to loan availability and delivery.

On July 16, 2014, RWT Financial, LLC (RWT Financial), a wholly-owned subsidiary of Redwood Trust, Inc., and the Federal Home Loan Bank of Chicago ("FHLBC") entered into an Advances, Collateral Pledge, and Security Agreement ("Advances Agreement"). The Advances Agreement governs the terms and conditions under which RWT Financial may incur borrowings, also referred to as "advances", from time to time, from the FHLBC secured by residential and commercial mortgage loans, and agency and private-label residential mortgage backed securities held at RWT Financial. As of the date of this report, there was $26 million of variable-rate advances outstanding (secured by residential mortgage loans) with a weighted average interest rate of 0.186% and a weighted average maturity of 2 years, as further described in Part I, Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q.

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

### INTRODUCTION

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

- Overview
- Results of Operations
- Liquidity and Capital Resources
- Off Balance Sheet Arrangements and Contractual Obligations
- Critical Accounting Policies and Estimates
- New Accounting Standards

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

References herein to "Redwood," the "company," "we," "us," and "our" include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in this "Management's Discussion and Analysis of Financial Condition and Results of Operations," our consolidated financial statements and notes thereto, which are included in Part I, Items 1 and 2 of this Quarterly Report on Form 10-Q.

Our website can be found at www.redwoodtrust.com. We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission ("SEC"). We also make available, free of charge, access to our charters for our Audit Committee, Compensation Committee, and Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code). In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-GAAP financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. Through the commercial section of our website, we also disclose information about our origination or acquisition of new commercial loans and other commercial investments, generally within five business days of origination or acquisition. We believe that this information may be of interest to investors in Redwood, although we may not always disclose on our website each new commercial loan or other new commercial investment we originate or acquire (or we may not disclose them on our website within the five business day period described above) due to, among other reasons, confidentiality obligations to the borrowers of those loans or counterparties to those investments. The information on our website is not part of this Quarterly Report on Form 10-Q.

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

### Our Business

Redwood Trust, Inc., together with its subsidiaries, is a specialty finance company focused on investing in mortgage- and other real estate-related assets and engaging in residential and commercial mortgage banking activities. We seek to invest in real estate- related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential

and commercial mortgage banking activities. We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. A description of these segments can be found in *Note 21* in Part I, Item 1 of this Quarterly Report on Form 10-Q.

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

For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust ("REIT") and we generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as "the REIT" or "our REIT." We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as "our operating subsidiaries" or "our taxable REIT subsidiaries" or "TRS." Our mortgage banking activities are generally carried out through our taxable REIT subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our taxable REIT subsidiaries, and to distribute as dividends at least 90% of the income we generate from the investment portfolio at our REIT.

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

*Consolidated Securitization Entities*

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

During the third quarter of 2011, we engaged in a transaction in which we resecuritized a pool of senior residential securities (the "Residential Resecuritization") primarily for the purpose of obtaining permanent non-recourse financing on a portion the residential securities we hold in our investment portfolio at the REIT. Similarly, during the fourth quarter of 2012, we engaged in a transaction in which we securitized a pool of commercial loans (the "Commercial Securitization") primarily for the purpose of obtaining permanent non-recourse financing on a portion of the commercial loans we hold in our investment portfolio at the REIT. In analyzing our results of operations, the Commercial Securitization and Residential Resecuritization are included in our results at Redwood as we view these transactions as a form of financing.

**Cautionary Statement**

This Quarterly Report on Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as "anticipate," "estimate," "will," "should," "expect," "believe," "intend," "seek," "plan" and similar expressions or their negative forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 and this Quarterly Report on Form 10-Q, in each case under the caption "Risk Factors." Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) statements we make regarding Redwood's business strategy and strategic focus, including statements relating to our confidence in our overall market position, strategy and long-term prospects, and our belief in the long-term efficiency of private label securitization as a form of mortgage financing; (ii) statements we make regarding the "three levers" that we expect to drive higher earnings and investment creation in our residential business; (iii) statements we make regarding our new business relationships with the Federal Home Loan Bank of Chicago (FHLBC), including our belief that these relationships will add new sellers and broaden the reach of our loan acquisition efforts by positioning us to acquire high balance residential loans from up to approximately 750 Federal Home Loan Bank members and provide us with access to collateralized financing for mortgage loans and securities, our expectations regarding the timing for commencing the acquisition program,

our statements relating to quantifying the acquisition opportunity, and statements related to potential uses for the financing that may be available from the FHBLC; (iv) statements we make regarding the potential for long-term growth and profitability in our conforming loan business, including our belief that it is a sound business decision to invest and build to position ourselves for the future, our belief that the pressure on margins that is broadly impacting the residential mortgage industry will gradually correct, as market capacity and pricing move back in line with origination volumes, our belief that we can improve our conforming loan sale margins by increasing loan purchase volumes and better leveraging the cost of our operating infrastructure, our belief that our conforming loan business also opens up opportunities to invest in retained servicing and potentially in credit risk transfers with Fannie Mae and Freddie Mac, and our statement that we are optimistic about reaching our goal of acquiring $1 billion of conforming loans per month by the end of 2014; (v) statements we make regarding the outlook for our commercial business, including our positioning to benefit from both an expanding economy and a substantial wave of maturing commercial loans that will need to be refinanced over the next few years, our belief that we are currently on track to exceed last year's origination volume and achieve our annual origination goal for commercial loans in 2014, while maintaining healthy margins, and our expectation to contribute approximately $300 million of senior loans to a third-party CMBS transaction in September; (vi) statements we make regarding the outlook for the mortgage market, including expectations relating to residential loan originations in 2014; (vii) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase or plan to purchase, including the amount of such loans that we have identified for purchase during the second quarter of 2014 and at June 30, 2014, statements relating to expected fallout and the corresponding volume of residential mortgage loans expected to be available for purchase, and statements relating to our estimate of the net market valuation adjustment associated with loans identified for purchase; (viii) statements relating to our estimate of our investment capacity (including that we estimate our investment capacity at June 30, 2014 to be approximately $62 million), our statement that we may need to source additional capital prior to the end of 2014, and our expectations relating to our ability to source capital internally, by selling or financing existing investments, and externally, via the issuance of convertible debt or common equity, other debt securities, or similar or other types of securities in public or private offerings; (ix) statements we make regarding our dividend policy and our process for determining dividends; and (x) statements regarding our expectations and estimates relating to the characterization for income tax purposes of our dividend distributions, our expectations and estimates relating to tax accounting, tax liabilities and tax savings, and GAAP tax provisions, our estimates of REIT taxable income and TRS taxable income, and our anticipation of additional credit losses for tax purposes in future periods (and, in particular, our statement that, for tax purposes, we expect an additional $40 million of tax credit losses on residential securities we currently own to be realized over an estimated three- to five-year period).

Important factors, among others, that may affect our actual results include: general economic trends, Federal Reserve monetary policy, the performance of the housing, commercial real estate, mortgage, credit, and broader financial markets, and their effects on

the prices of earning assets and the credit status of borrowers; federal and state legislative and regulatory developments, and the actions of governmental authorities, including those affecting the mortgage industry or our business; our exposure to credit risk and the timing of credit losses within our portfolio; the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own; the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks; changes in credit ratings on assets we own and changes in the rating agencies' credit rating methodologies; changes in interest rates; changes in mortgage prepayment rates; the availability of assets for purchase at attractive prices and our ability to reinvest cash we hold; changes in the values of assets we own; changes in liquidity in the market for real estate securities and loans; our ability to finance the acquisition of real estate-related assets with short-term debt; the ability of counterparties to satisfy their obligations to us; our involvement in securitization transactions, the timing and profitability of those transactions, and the risks we are exposed to in engaging in securitization transactions; exposure to claims and litigation, including litigation arising from our involvement in securitization transactions; whether we have sufficient liquid assets to meet short-term needs; our ability to successfully compete and retain or attract key personnel; our ability to adapt our business model and strategies to changing circumstances; changes in our investment, financing, and hedging strategies and new risks we may be exposed to if we expand our business activities; exposure to environmental liabilities and the effects of global climate change; failure to comply with applicable laws and regulations; our failure to maintain appropriate internal controls over financial reporting and disclosure controls and procedures; the impact on our reputation that could result from our actions or omissions or from those of others; changes in accounting principles and tax rules; our ability to maintain our status as a REIT for tax purposes; limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940; decisions about raising, managing, and distributing capital; and other factors not presently identified.

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

## OVERVIEW

### Business Update

During the second quarter, we continued to make measurable progress in actively managing, investing and positioning our residential and commercial businesses for long-term growth and to build sustainable franchise value.

We believe that the "three levers" that will drive higher earnings and investment creation in our residential business are (i) increasing the types of mortgage loan products we acquire, (ii) increasing the number of counterparties from whom we acquire mortgage loans (we refer to these counterparties as loan sellers), and (iii) increasing our options for the ultimate disposition of the loans we acquire (e.g., whole loan sales or securitization). We made significant progress on all of these fronts during the second quarter, including the recent announcement of our new business relationships with the Federal Home Loan Bank of Chicago ("FHLBC"). We believe one of these relationships will add new loan sellers and broaden the reach of our loan acquisition efforts by positioning us to acquire high balance residential loans from up to approximately 750 Federal Home Loan Bank members that participate in the FHLBC's Mortgage Partnership Finance® Program. The other relationship is through our wholly-owned subsidiary, RWT Financial LLC, which has become a member of the FHLBC. This relationship provides RWT Financial with access to collateralized financing for mortgage loans and securities, while contributing to the Federal Home Loan Bank system's mission of funding residential mortgage lending.

Despite improvements in key growth metrics, our near-term quarterly earnings remain under pressure and are lagging the progress we see in our operations. The earnings from our commercial mortgage banking business and our investment portfolio continue to be in line with, or ahead of, our expectations. The primary earnings pressure we face currently relates to our residential mortgage banking business. While our established jumbo loan mortgage banking activities continue to produce healthy returns, our expansion into conforming loan mortgage banking activities is being impacted, in particular, by two significant factors. First, industrywide gain-on-sale margins for conforming loans remain under pressure as refinance origination volumes decrease. Second, we are incurring upfront costs as we build our operations and systems to facilitate long-term growth and profitability. As a result, our conforming loan sale margins are near break-even before taking into account related personnel and overhead expenses. Although this expansion has placed near-term pressure on earnings, overall, we think it is a sound business decision to invest and build to position ourselves for the future.

Ultimately, we believe the pressure on margins that is broadly impacting the residential mortgage industry will gradually correct, as market capacity and pricing move back in line with origination volumes. Additionally, we believe we can improve our conforming loan sale margins by increasing loan purchase volumes and better leveraging the cost of our operating infrastructure. Our conforming loan business also opens up opportunities to invest in retained servicing and potentially in credit risk transfers with Fannie Mae and Freddie Mac (the "Agencies").

In our commercial mortgage banking business, we continue to build our brand as a provider of senior and mezzanine financing for a variety of stabilized property types. We have an experienced commercial team that is performing well in terms of its growth metrics and its contribution to earnings, and we ended the second quarter with a strong commercial mortgage pipeline. They have positioned us to benefit from both an expanding economy that is driving property fundamentals in the right direction and a substantial wave of maturing commercial loans that will need to be refinanced over the next few years. To take advantage of this opportunity, we are adding originators and support staff. While the market for originating commercial loans remains highly competitive, putting pressure on margins over time, we believe we are currently on track to exceed last year's origination volume and achieve our origination goals for 2014, while maintaining healthy margins.

We remain highly focused on positioning Redwood for long-term growth and building sustainable franchise value. While external market factors may temporarily aid or hinder our progress in any given quarter, we are working on the "three levers" we referenced above that we believe will drive our residential business forward. Our more established jumbo and commercial mortgage banking activities are generating attractive earnings, and over time we expect to see similar results from our conforming mortgage banking activities. We remain excited about the potential need for private capital to play a larger role in the residential mortgage market, and the ways Redwood can participate.

**Financial and Operational Overview – Second Quarter of 2014**

We made great progress on some of our long-term initiatives during the second quarter of 2014 while generating positive momentum in both our residential and commercial businesses. In our residential business, we achieved a significant increase in loan acquisition volume compared to the first quarter of 2014, and our pipeline of both jumbo and conforming loans remained strong at quarter-end. Our commercial origination activity grew compared to the first quarter of 2014, ending the second quarter with a record pipeline of senior commercial loans under application.

In June 2014, we announced an agreement with the FHLBC to purchase high-balance residential loans through the FHLBC's Mortgage Partnership Finance® (MPF®) Program under the MPF Direct™ Product (MPF Direct). We expect the program to commence early in the fourth quarter of 2014. We also announced that our subsidiary, RWT Financial, LLC, was approved as a member in the FHLBC, and this new subsidiary is currently using borrowings from the FHLBC to finance certain jumbo loans.

Following is a summary of Redwood's second quarter 2014 results:

- Earnings per share were $0.18 for the second quarter of 2014, up from $0.14 per share in the first quarter of 2014. The increase in earnings per share is largely attributable to higher mortgage banking income, particularly from our commercial mortgage banking activities, combined with a steady contribution of net interest income from our investment portfolio.

- Our GAAP book value per share was $15.03 at June 30, 2014, a decrease from $15.14 per share at March 31, 2014. The second quarter decline is net of $0.18 per share of net income and $0.15 per share of net unrealized gains on securities, and also reflects the $0.28 per share second quarter dividend paid to shareholders and an increase in shares outstanding related to our annual distribution of common stock underlying vested equity awards.

- Our residential loan acquisition volume was $1.8 billion in the second quarter of 2014, up 64% from the first quarter of 2014. At June 30, 2014, our pipeline of loans identified for purchase was $2.0 billion and included $1.6 billion of jumbo loans and $0.4 billion of conforming loans, unadjusted for fallout expectations. (When we refer to fallout we are referring to the percentage of loans that, although identified for purchase, are not ultimately purchased, including due to the loan not closing with the borrower.)

- We originated $149 million of senior commercial loans and $6 million of mezzanine commercial loans in the second quarter of 2014. Our senior commercial loan pipeline, defined as loans under application, totaled $347 million at June 30, 2014.

- Our residential securities portfolio increased by 6%, or $102 million, to $1.8 billion at June 30, 2014, from $1.7 billion at March 31, 2014.

At June 30, 2014, our GAAP book value was $1.2 billion, or $15.03 per share, a decrease from $15.14 per share at March 31, 2014. The following table sets forth the changes in Redwood's GAAP book value per share for the second and first quarters of 2014.

***Table 1 – Changes in Book Value per Share***

| (In Dollars, per share basis) | Three Months Ended June 30, 2014 | Three Months Ended March 31, 2014 |
|---|---|---|
| Beginning book value per share | $ 15.14 | $ 15.10 |
| Net income | 0.18 | 0.14 |
| Changes in unrealized gains/losses, net | 0.15 | 0.25 |
| Unrealized losses on hedges, net | (0.06) | (0.11) |
| Equity awards distributions | (0.14) | (0.02) |
| Other, net | 0.04 | 0.06 |
| Dividends | (0.28) | (0.28) |
| **Ending Book Value per Share** | $ 15.03 | $ 15.14 |

The decrease in GAAP book value per share shown above primarily resulted from dividends paid in excess of GAAP earnings, combined with an increase in shares outstanding related to our annual distribution of common stock underlying vested equity awards in May 2014. These effects were partially offset by net unrealized gains, primarily resulting from an increase in the market value of our securities during the second quarter of 2014.

***Residential Mortgage Banking Market Conditions***

The residential mortgage market improved in the second quarter of 2014 after a steep decline in industry origination volume in the first quarter of 2014, but remained down compared to the year-ago period. Despite stronger economic data, interest rates generally fell during the second quarter of 2014. The 10-year Treasury rate fell to 2.52% on June 30, 2014, from 2.72% on March 31, 2014, which resulted in higher overall industry origination volume during the second quarter. While the Mortgage Bankers Association of America projected second quarter originations to increase by 18% compared to the first quarter (and to decline by 40% annually in 2014), many market participants believe that second quarter originations have exceeded those projections.

In the second quarter of 2014, we continued to advance our residential mortgage banking business in what is still a challenging operating environment. We expanded our residential business by adding loan sellers – the number of sellers has increased by 19% year-to-date, to 140 sellers at June 30, 2014. This contributed to a record $3.2 billion of loans identified for purchase during the second quarter of 2014, up from $1.7 billion in the prior quarter. In addition, with the upcoming launch of MPF Direct with the FHLBC, we expect to add a substantial number of new loan sellers over the next few years. Our conforming loan activity continues to ramp up as well, following the initiation of this activity in the fourth quarter of 2013. We added new loan sellers and several of our existing jumbo loan sellers also began to sell conforming loans to us in the second quarter. This led to $868 million of conforming loan acquisitions in the second quarter of 2014, a 190% increase compared to the first quarter of 2014. Based on our recent activity, we are optimistic about reaching our goal of acquiring $1 billion of conforming loans per month by the end of 2014.

Private-label securitization activity remained subdued during the second quarter of 2014, but showed signs of improvement. Our recent July Sequoia securitization (SEMT 2014-2) was met with strong investor interest and the triple-A rated securities priced at levels that were better than our April 2014 (SEMT 2014-1) securitization. When we consider the profitability, franchise value, and ability to create investments for our investment portfolio, securitization of loans through our Sequoia platform is becoming more competitive with whole loan sales, which significantly outpaced securitization activity in the first quarter of 2014.

During the second quarter of 2014 we also continued to make progress on acquiring non-Qualified Mortgage (non-QM) loans and on potential conforming loan credit risk transfer transactions. We included a small number of non-QM loans in our July Sequoia securitization and were satisfied with the execution and investor reception. As a result, in early August we expanded the types of jumbo loans we acquire to include non-QM loans with characteristics similar to those of jumbo loans we had historically acquired prior to the implementation of the Consumer Finance Protection Bureau's QM regulations in early 2014.

***MPF Direct™ Loan Purchase Program***

In June we announced a new business relationship with the FHLBC under which we will purchase high-balance mortgage loans that are originated by participating member banks in various Federal Home Loan Bank districts. This business relationship is separate and distinct from our subsidiary's membership in the FHLBC. In summary, we will be able to purchase, through the FHLBC (as administrator of the MPF Program), high-balance residential mortgage loans that conform to our underwriting standards from member banks that participate in the MPF Program. Eligible loans will generally have balances between $417,000 and $729,270. There are 12 Federal Home Loan Banks (FHLBanks) located throughout the U.S. and more than 7,400 total members (banks, thrifts, insurance companies, and credit unions), of which about 750 members are currently active MPF Program participants that could sell us high balance loans under MPF Direct. Ten of the FHLBanks offered their members the opportunity to participate in the MPF Program as of June 30, 2014. We are currently working with the FHLBC to identify a target list of potential sellers from within the FHLBC, with the goal of beginning a test phase of MPF Direct early in the fourth quarter of 2014. After the test phase, we plan to roll out MPF Direct to other participating FHLBanks. At this time, it is too early to quantify the overall opportunity, which we believe could be substantial over time.

***Commercial Mortgage Banking Market Conditions***

In the second quarter of 2014, our commercial team increased originations and generated higher loan sale profit margins compared to the first quarter of 2014. We remain optimistic that our positive momentum will enable us to achieve our annual origination goal for 2014. During the second quarter, we originated 15 senior commercial loans totaling $149 million, as compared to six loans totaling $119 million in the first quarter of 2014. We entered the third quarter with our largest-ever pipeline of loans under application at $347 million, and in September expect to contribute approximately $300 million of senior loans to a CMBS transaction sponsored by a third party.

***Quarterly Investment Activity***

Our capital deployment moderately increased in the second quarter of 2014, from the prior quarter levels, as a result of securities we retained from the Sequoia securitization we completed in April. The following table details our capital invested for the second quarter of 2014.

***Table 2 – Investment Activity***

| (In Millions) (1) | Three Months Ended June 30, 2014 | Three Months Ended March 31, 2014 |
|---|---|---|
| Residential investments | | |
| Sequoia RMBS | $ 85 | $ - |
| Third-Party RMBS (2) | 56 | 74 |
| Less: Short-term debt | (121) | (67) |
| MSR investments | 12 | 3 |
| Net residential investments | 32 | 10 |
| Commercial investments | | |
| Commercial mezzanine investments | 6 | 2 |
| Commercial B-notes | - | 5 |
| Less: Borrowings | (2) | (2) |
| Net commercial investments | 4 | 5 |
| **Equity Capital Invested** | $ 36 | $ 15 |

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

(2) Included in our third-party RMBS acquisitions was $4 million of acquisitions late in the second quarter of 2014 that did not settle until early in the third quarter of 2014. In order to reflect the fact that capital had not yet been used to acquire these assets at June 30, 2014, the short-term debt / other liabilities line item in the table above includes a $4 million payable associated with these transactions. In early July 2014, we completed the purchase of these securities using $4 million of short-term debt, resulting in net capital invested of $0.4 million that is not reflected in the table above.

At June 30, 2014, our residential securities portfolio had a market value of $1.8 billion, up from $1.7 billion at March 31, 2014. This increase included $142 million of acquisitions, $3 million in positive valuation adjustments, $10 million in discount accretion, and $53 million in net principal paydowns. Included in these numbers are $159 million of Sequoia senior and IO securities, which are included in our Residential Mortgage Banking segment for financial reporting purposes.

Our residential securities acquisitions of $142 million in the second quarter of 2014 included $115 million of senior securities, $20 million of subordinate securities retained from our Sequoia 2014-1 securitization, and $7 million of additional subordinate securities purchased from third parties. These acquisitions were funded with $121 million of short-term debt and $21 million of capital. We also invested $6 million in commercial mezzanine loans. Finally, we added $12 million of MSRs in the second quarter of 2014 associated with $1.2 billion of residential loans serviced, increasing our investment in MSRs to $71 million associated with $7.1 billion of residential loans serviced.

Following the end of the second quarter of 2014 and through July 31, 2014, we acquired $22 million of securities from SEMT 2014-2, and $6 million of MSR investments.

***Capital and Liquidity***

During June 2014, our subsidiary, RWT Financial, LLC, was approved as a member of the FHLBC. This membership provides RWT Financial with access to attractive short- and long-term financing options that broaden our sources of liquidity and potentially increase investment opportunities for us that require tailored funding. Because there is no amount of financing that the FHLBC has committed to provide to RWT Financial at any given time, we may not be able to obtain additional financing from FHLBC when we request it. At July 31, 2014, we had utilized $26 million of FHLBC advances to fund $30 million of jumbo residential loans. In future periods, RWT

Financial may seek to use financing from the FHLBC for MPF Direct loans we acquire through the FHLBC. However, our agreement with the FHLBC relating to MPF Direct is separate from RWT Financial's membership in the FHLBC. Any limitation on RWT Financial's ability to borrow from FHLBC would not necessarily impact our ability to acquire MPF Direct loans.

At June 30, 2014, we held $157 million in cash, and our investment capacity (defined as the approximate amount of capital we had readily available for long-term investments) was estimated to be approximately $62 million. Total capital of $1.7 billion at June 30, 2014, included $1.2 billion of equity capital, $140 million of long-term debt, and $288 million of long-term convertible debt.

While we had previously expected our available capital and liquidity to be sufficient to fund our business and investment objectives for most of 2014, as a result of improving market conditions, our rate of capital deployment in the second half of 2014 may require us to source additional capital prior to the end of the year. As we have stated in the past, we look first to our own balance sheet for attractive opportunities to raise capital through sales or financings of assets before we look externally. Since the end of the second quarter of 2014, we sold $229 million of third party securities generating net proceeds to Redwood of $21 million after repaying the associated financing. Should we decide we need to raise additional external capital to fund our business activities, we would consider the issuance of convertible debt securities under the shelf registration statement we currently have on file with the SEC, as well as the issuance of common equity, other debt securities, or similar or other types of securities in public or private offerings.

**RESULTS OF OPERATIONS**

The following table presents the components of our GAAP net income for the three and six months ended June 30, 2014 and 2013.

***Table 3 – Net Income***

| (In Millions, Except per Share Data) (1) | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| Interest income | $ 58 | $ 58 | $ 113 | $ 111 |
| Interest expense | (21) | (21) | (40) | (40) |
| **Net Interest Income** | 37 | 36 | 73 | 72 |
| Reversal of provision (provision) for loan losses | 0 | 3 | (1) | 1 |
| **Net Interest Income After Provision** | 37 | 40 | 72 | 73 |
| **Noninterest Income** | | | | |
| Mortgage banking activities, net | 6 | 49 | 6 | 94 |
| MSR income, net | (2) | 11 | (1) | 12 |
| Other market valuation adjustments, net | (4) | (6) | (10) | (7) |
| Realized gains, net | 1 | 1 | 2 | 13 |
| Total noninterest income (loss), net | 1 | 54 | (3) | 112 |
| Operating expenses | (22) | (24) | (42) | (45) |
| Net income before provision for income taxes | 16 | 69 | 27 | 140 |
| (Provision for) benefit from income taxes | (0) | (3) | 2 | (14) |
| **Net Income** | $ 16 | $ 66 | $ 28 | $ 126 |
| Diluted earnings per common share | $ 0.18 | $ 0.71 | $ 0.32 | $ 1.40 |

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

*Net Interest Income*

During the second quarter of 2014, net interest income increased by $1 million to $37 million, as compared to $36 million during the second quarter of 2013. During the first six months of 2014, net interest income increased by $1 million to $73 million, as compared to $72 million during the first six months of 2013.

The increase in net interest income in both periods was primarily due to an increase in the average balance of investments we retained from Sequoia securitizations and third party investments we acquired over the past year. The increase in net interest income from these investments was partially offset by lower net interest income from residential loans held-for-sale as the average balance of loans accumulated for sale or securitization declined.

Additional detail on changes in net interest income is provided in the "*Net Interest Income*" section of this MD&A.

*Provision for Loan Losses*

We maintain an allowance for loan losses for both our commercial loan investment portfolio and the residential loans held-for-investment from our consolidated legacy Sequoia entities.

Provisions for loan losses for our commercial portfolio were less than $1 million in the first and second quarters of 2014 and 2013 and are primarily associated with higher balances of loans outstanding in each successive period as we continue to originate loans into this portfolio.

The provisions from the commercial portfolio were offset by reversals of provisions for loan losses at legacy Consolidated Sequoia Entities during the second quarters of 2014 and 2013. Over the past several quarters, the credit performance on our legacy Sequoia loan portfolio has generally improved, resulting in reductions to the associated allowance for loan losses. Additional information on the allowance for loan losses on our Legacy Consolidated Sequoia Entities is provided in the "*Results of Legacy Consolidated Entities*" section of this MD&A.

*Mortgage Banking Activities, Net*

Income from mortgage banking activities includes results from both our residential and commercial mortgage banking operations. The decrease in both the second quarter and first half of 2014 as compared to the same periods in 2013 was largely attributable to our residential mortgage banking activities.

Income from residential mortgage banking activities decreased to $1 million in the second quarter of 2014, as compared to $42 million during the second quarter of 2013 and decreased to $6 million in the first six months of 2014, as compared to $82 million during the first six months of 2013. The decline in both periods primarily resulted from a timing difference we experienced in the second quarter of 2013, related to our jumbo mortgage pipeline (defined as those loans we have identified for purchase) and the hedging derivatives associated with those loans. At June 30, 2013, we estimated that the net market valuation adjustment associated with loans identified for purchase was approximately negative $34 million, which was not recognized in earnings, whereas the gains from derivatives associated with those loans were included in earnings.

The decline in both periods was also attributable to a combination of reduced residential loan acquisition volumes, resulting from higher mortgage rates and lower industry origination volumes, and lower loan sale profit margins. The lower overall profit margins resulted from increased competition, particularly for conforming loans, which have become a larger portion of our overall loan acquisitions during the last two quarters.

Income from commercial mortgage banking activities was consistent in the second quarters of 2014 and 2013, and decreased to $6 million in the first six months of 2014, as compared to $13 million in the first six months of 2013. The decrease during the six-month period resulted from both lower origination volumes and lower loan sale profit margins in 2014.

Additional detail on our residential and commercial mortgage banking results are included in the Residential Mortgage Banking, and Commercial Mortgage Banking and Investment portions of the "*Segment Results*" section of this MD&A.

*MSR Income, Net*

MSR income is comprised of both the net fee income earned from MSRs and their market value changes. During the second quarter of 2014, MSR income declined by $13 million to a loss of $2 million, as compared to income of $11 million during the second quarter of 2013. During the first six months of 2014, MSR income declined by $13 million to a loss of $1 million, as compared to income of $12 million during the first six months of 2013. The net cash we received from our MSRs has steadily increased over the past several quarters due to additional MSR investments as we continued to securitize jumbo loans and increased our conforming loan purchases. During the second quarter and first six months of 2014, we received $4 million and $7 million in net servicing fees, respectively, as compared to $2 million during each of the comparable periods of 2013.

During the second quarter and first six months of 2014, market valuation adjustments on MSRs were negative $6 million and negative $8 million, respectively, as compared to positive $9 million during both of the comparable periods of 2013. Mortgage rates have declined in 2014, which has adversely affected the valuation of our MSRs during that time period. During the first six months of 2013, mortgage rates increased, which benefited the valuation of our MSRs.

Additional detail on our investment in MSRs is included in the Residential Investments portion of the "*Segment Results*" section of this MD&A.

*Other Market Valuation Adjustments, Net*

Other market valuation adjustments, net, for the three and six months ended June 30, 2014 included an expense of $4 million and $9 million, respectively, attributable to declines in the value of derivatives used to manage risks associated with certain of our residential investment securities. These derivatives declined in value as a result of declining interest rates during the first six months of 2014. Changes in the value of the securities being hedged by these derivatives were recorded in other comprehensive income on our balance sheet and were not recognized in net income. Additional expenses of less than $1 million in both the three and six month periods ended June 30, 2014, relate to impairments on certain AFS securities and the changes in value of certain securities carried at fair value on our financial statements. For the three and six months ended June 30, 2013, other market valuation adjustments, net, includes impairments on AFS securities of $2 million and an expense of $4 million and $5 million, respectively, due to the decline in the market value of certain fair value securities.

*Realized Gains, Net*

Realized gains, net, were $1 million in both the second quarter of 2014 and 2013. Realized gains, net, for the first six months of 2014 were $2 million, as compared to $13 million for the first six months of 2013. During the first six months of 2014, we realized gains from certain securities that were sold and called. During the first six months of 2013, the majority of our realized gains were from the sale of $14 million of available-for-sale securities for gains of $12 million.

For additional detail on realized gains, see the Residential Investments portion of the "*Segment Results*" of this MD&A.

*Operating Expense*

During the second quarter of 2014, operating expenses decreased by $2 million to $22 million, as compared to $24 million during the second quarter of 2013. During the first six months of 2014, operating expenses decreased by $3 million to $42 million, as compared to $45 million during the first six months of 2013. The decline over both periods is primarily due to a decline in severance-related expenses and variable compensation accruals. During the first six months of 2014, we recorded less than $1 million of severance-related expenses, as compared to an expense of $3 million during the first six months of 2013. These reductions in expenses were partially offset by increases in fixed compensation and systems and consulting expenses that have increased over the last year as we expanded our residential and commercial mortgage banking operations.

*Provision for Income Taxes*

We recorded a tax provision of less than $1 million during the second quarter of 2014, as compared to a tax provision of $3 million during the second quarter of 2013. We recorded a benefit from income taxes of $2 million in the first six months of 2014 as compared to a tax provision of $14 million during the first six months of 2013. Our provision for income taxes is primarily driven by activity at our taxable REIT subsidiaries, including our residential and commercial mortgage banking activities and MSR investments. Higher tax provisions during the second quarter and first six months of 2013 was primarily the result of higher income from our mortgage banking activities during these periods.

For additional detail on income taxes, see the "*Taxable Income*" section of this MD&A.

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*Net Interest Income*

The following tables present the components of net interest income for the three and six months ended June 30, 2014 and 2013.

*Table 4 – Net Interest Income* [1]

| | Three Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2014 | | | 2013 | | |
| (Dollars in Millions) | Interest Income/ (Expense) | Average Balance [2] | Yield | Interest Income/ (Expense) | Average Balance [2] | Yield |
| **Interest Income** | | | | | | |
| Residential loans, HFS | $ 7 | $ 740 | 3.89 % | $ 10 | $ 1,060 | 3.79 % |
| Residential loans, HFI [3] | 6 | 1,642 | 1.56 % | 9 | 2,044 | 1.72 % |
| Commercial loans, HFS | 1 | 75 | 4.41 % | 1 | 50 | 6.56 % |
| Commercial loans, HFI | 10 | 413 | 10.05 % | 9 | 332 | 10.60 % |
| Trading securities | 6 | 182 | 13.46 % | 7 | 102 | 26.87 % |
| Available-for-sale securities | 27 | 1,471 | 7.35 % | 22 | 1,002 | 8.89 % |
| Cash and cash equivalents | 0 | 132 | 0.02 % | 0 | 97 | 0.56 % |
| **Total interest income** | 58 | 4,656 | 4.98 % | 58 | 4,688 | 4.93 % |
| **Interest Expense** | | | | | | |
| Short-term debt | (5) | 1,330 | (1.55) % | (5) | 1,054 | (1.78) % |
| ABS issued - Redwood | (3) | 213 | (5.45) % | (4) | 295 | (4.78) % |
| ABS issued - Sequoia [3] | (5) | 1,578 | (1.33) % | (7) | 1,965 | (1.37) % |
| Long-term debt | (8) | 531 | (5.89) % | (6) | 434 | (5.98) % |
| **Total interest expense** | (21) | 3,655 | (2.31) % | (21) | 3,747 | (2.29) % |
| **Net Interest Income** | $ 37 | | | $ 36 | | |

| | Six Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2014 | | | 2013 | | |
| (Dollars in Millions) | Interest Income/ (Expense) | Average Balance [2] | Yield | Interest Income/ (Expense) | Average Balance [2] | Yield |
| **Interest Income** | | | | | | |
| Residential loans, HFS | $ 13 | $ 630 | 4.14 % | $ 18 | $ 940 | 3.75 % |
| Residential loans, HFI [3] | 13 | 1,677 | 1.58 % | 19 | 2,110 | 1.79 % |
| Commercial loans, HFS | 2 | 72 | 5.14 % | 1 | 50 | 3.28 % |
| Commercial loans, HFI | 20 | 389 | 10.16 % | 19 | 326 | 11.64 % |
| Trading securities | 12 | 153 | 15.53 % | 11 | 74 | 29.21 % |
| Available-for-sale securities | 54 | 1,434 | 7.49 % | 44 | 965 | 9.12 % |
| Cash and cash equivalents | 0 | 145 | 0.01 % | 0 | 88 | 0.34 % |
| **Total interest income** | 113 | 4,499 | 5.04 % | 111 | 4,553 | 4.89 % |
| **Interest Expense** | | | | | | |
| Short-term debt | (9) | 1,169 | (1.53) % | (8) | 954 | (1.78) % |
| ABS issued - Redwood | (6) | 223 | (5.31) % | (7) | 306 | (4.72) % |
| ABS issued - Sequoia [3] | (11) | 1,611 | (1.33) % | (14) | 2,032 | (1.38) % |
| Long-term debt | (15) | 506 | (5.78) % | (10) | 330 | (6.08) % |
| **Total interest expense** | (40) | 3,509 | (2.29) % | (40) | 3,622 | (2.19) % |
| **Net Interest Income** | $ 73 | | | $ 72 | | |

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

(2) Average balances for residential and commercial loans held-for-sale and trading securities are calculated based upon carrying values, which represent estimated fair values. Average balances for available-for-sale securities and debt are calculated based upon amortized historical cost.

(3) The interest income from residential loans held-for-investment and the interest expense from ABS issued - Sequoia represent activity from our Legacy Consolidated Entities.

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*Analysis of Changes in Net Interest Income*

Net interest income increased by $1 million to $37 million in the second quarter of 2014 and increased by $1 million to $73 million in the first six months of 2014, as compared to $36 million and $72 million in the respective periods in 2013. The following analysis of changes in net interest income is organized according to the results of our three business segments. Additional details regarding the activities impacting net interest income at each segment are included in the "*Segment Results*" section of this MD&A.

Our residential investments segment contributed $25 million and $50 million of net interest income for the second quarter of 2014 and the first six months of 2014, respectively, and contributed $21 million and $42 million to the net interest income from the same respective periods in 2013. Increases in interest income from higher average balances of AFS securities during 2014 were partially offset by lower yields. The higher average balances in 2014 resulted from new investments made in 2013 and 2014 exceeding principal pay downs and sales. The decrease in yields was primarily related to lower unlevered yields available, in general, for new investments made in 2013 and 2014 relative to investments acquired in prior years that continue to pay down.

Our residential mortgage banking segment contributed $10 million of net interest income in the second quarter of 2014 and $20 million in the first six months of 2014, a decline of $2 million from the second quarter of 2013, and unchanged compared with the first six months of 2013. During the second quarter and first six months of 2014, net interest income declines were attributable to lower balances of loans held-for-sale as compared to the same periods in 2013. During the first six months of 2014, these declines were partially offset by additional interest income earned on higher balances of Sequoia interest only ("IO") securities acquired during the past year that are used as hedges for this segment.

Our commercial mortgage banking and investments segment contributed $7 million of net interest income for the second quarter of 2014 and $14 million for the first six months of 2014, consistent with the same periods in 2013. Growth in our commercial loans held-for-investment portfolio was partially funded with long-term debt, marginally increasing interest expense at this segment.

During the second quarter and first six months of 2014, respectively, total net interest income of $42 million and $83 million generated at our three business segments was offset by $5 million and $10 million of net interest expense not directly allocated to our three business segments. These unallocated amounts are presented in the corporate/other reconciling column in our segment results and include net interest income from Legacy Consolidated Entities and interest expense related to long-term debt. Interest expense from long-term debt not directly allocated to our segments was $6 million and $12 million during the second quarter and first six months of 2014, respectively. This was unchanged from the second quarter of 2013 and an increase of $2 million from the first six months of 2013. The increase from the first six months of 2013 primarily resulted from the issuance of convertible debt at the end of the first quarter of 2013. Contributions to net interest income from Legacy Consolidated Entities were $1 million and $2 million in the second quarter of 2014 and 2013, respectively, and $3 million and $5 million in the first six months of 2014 and 2013, respectively. Additional details regarding Legacy Consolidated Entities are included in the "*Results from Legacy Consolidated Entities*" section of this MD&A.

The following table presents the net interest rate spread between the yield on unsecuritized loans and securities and their specific debt financing costs at June 30, 2014.

***Table 5 – Interest Expense — Specific Borrowing Costs***

| **June 30, 2014** | **Residential Loans** | **Commercial Loans** | **Residential Securities** |
|---|---|---|---|
| Asset yield | 3.94% | 4.60% | 5.65% |
| Short-term debt yield | 1.72% | 2.40% | 1.31% |
| **Net interest rate spread** | 2.22% | 2.20% | 4.34% |

For additional discussion on short-term debt including information regarding margin requirements and financial covenants see "*Risks Relating to Short-Term Debt Incurred Under Residential Mortgage Loan Warehouse Facilities, Securities Repurchase Facilities, and Other Short-Term Debt Facilities; and Risks Relating to Debt Incurred Under Commercial Debt Investment Repurchase Facilities*" in the "*Liquidity and Capital Resources*" section below.

**Segment Results**

The following is a discussion of the results of operations for our three business segments for the three and six months ended June 30, 2014 and 2013. For additional information on our segments, refer to *Note 21* in Part I, Item I of this Quarterly Report on Form10-Q.

***Residential Mortgage Banking***

The following table presents the components of segment contribution for the residential mortgage banking segment for the three and six months ended June 30, 2014 and 2013.

***Table 6 – Residential Mortgage Banking Segment Contribution***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Interest income | $ 12,438 | $ 15,158 | $ 23,104 | $ 24,914 |
| Interest expense | (2,161) | (3,020) | (3,482) | (5,130) |
| **Net interest income** | 10,277 | 12,138 | 19,622 | 19,784 |
| Other market valuation adjustments, net | 13 | 38 | 11 | 78 |
| Mortgage banking activities, net | 1,329 | 42,290 | 265 | 81,514 |
| Direct operating expenses | (9,501) | (6,053) | (16,595) | (10,691) |
| Benefit from (provision for) income taxes | 259 | (2,409) | 94 | (11,314) |
| **Segment Contribution** | $ 2,377 | $ 46,004 | $ 3,397 | $ 79,371 |

The following table provides the activity of unsecuritized residential loans during the three and six months ended June 30, 2014 and 2013.

***Table 7 – Unsecuritized Residential Loans — Activity***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Balance at beginning of period | $ 774,936 | $ 831,953 | $ 404,267 | $ 562,658 |
| Acquisitions | 1,790,909 | 2,567,426 | 2,883,880 | 5,154,325 |
| Sales | (1,466,956) | (2,135,166) | (2,189,358) | (4,484,255) |
| Principal repayments | (5,006) | (1,768) | (12,032) | (5,054) |
| Changes in fair value, net | 13,994 | (41,347) | 21,120 | (6,576) |
| **Balance at End of Period** | $ 1,107,877 | $ 1,221,098 | $ 1,107,877 | $ 1,221,098 |

The following table provides the activity of our retained Sequoia IO securities for the three and six months ended June 30, 2014 and 2013.

***Table 8 – Sequoia IO Securities Activity***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Beginning fair value | $ 106,228 | $ 55,289 | $ 110,505 | $ 10,409 |
| Acquisitions | - | 40,642 | - | 91,850 |
| Sales | - | (8,676) | - | (16,933) |
| Change in fair value, net | (9,334) | 36,336 | (13,611) | 38,265 |
| **Ending Fair Value** | $ 96,894 | $ 123,591 | $ 96,894 | $ 123,591 |

During the second quarter of 2014, we purchased $1.8 billion of residential loans, which included $868 million of conforming loans and $923 million of prime jumbo loans. We sold $757 million of conforming loans to the Agencies and $357 million of jumbo loans to third parties. In addition, we securitized $353 million of jumbo loans as part of a Sequoia securitization, which settled in early April 2014. We retained $62 million of senior securities, $20 million of subordinate securities and $12 million of MSR investments, from a combination of the loan sales and the securitization. At June 30, 2014, we owned $1.1 billion of prime residential loans, including $848 million of jumbo loans and $260 million of conforming loans. At June 30, 2014, our pipeline of loans identified for purchase included $1.1 billion of jumbo loans and $360 million of conforming loans (adjusted for expected fallout).

*Net Interest Income*

Net interest income from residential mortgage banking is primarily comprised of interest income earned on residential loans from the time we purchase the loans to when we sell or securitize them, offset by interest expense incurred on short-term warehouse debt used in part to finance the loans while we hold them on balance sheet. Net interest income also includes interest income from Sequoia IO securities that are used to mitigate certain risks related to interest rate movements on our residential loan pipeline.

During the second quarter of 2014, net interest income from loans held on balance sheet prior to sale decreased to $7 million from $10 million in the second quarter of 2013, primarily due to a lower average balance of loans outstanding during the current quarter. Interest income from Sequoia IO securities was $5 million in the second quarter of both 2014 and 2013.

During the first six months of 2014, net interest income from loans held on balance sheet prior to sale decreased to $9 million from $12 million in the first six months of 2013, primarily due to a lower average loan balance in the current six month period. Interest income from Sequoia IO securities increased to $10 million from $7 million in the first six months of 2013, fully offsetting the decline from lower average loan balances. The increase in interest income from Sequoia IO securities resulted from higher average balances of IO securities, which we retained from Sequoia securitizations we completed during 2013 and 2014.

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

*Mortgage Banking Activities, Net*

Mortgage banking activities, net, include the changes in market value associated with both the loans we hold on balance sheet prior to sale, as well as the derivative instruments and Sequoia IO securities we use to manage risks associated with our loans held-for-sale and loans identified for purchase. Our loan sale profit margins are measured over the period from which we identify a loan for purchase and subsequently sell or securitize the loan and may be realized over the course of one or more quarters for financial reporting purposes.

The following table presents the components of mortgage banking activities, net, from residential mortgage banking. Amounts presented include both the changes in market values for loans that were sold and associated derivative positions that were settled during the periods presented as well as changes in market values of loans, derivatives and Sequoia IO securities we owned as of the period end.

***Table 9 – Components of Residential Mortgage Banking Activities, Net***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Changes in fair value of: | | | | |
| Residential loans, at fair value | $ 13,375 | $ (41,405) | $ 20,403 | $ (6,535) |
| Sequoia securities | (8,810) | 36,336 | (13,087) | 38,265 |
| Risk management derivatives | (7,858) | 46,621 | (12,136) | 48,508 |
| Purchase and forward sale commitments | 3,582 | - | 3,590 | - |
| Other fees | 1,040 | 738 | 1,495 | 1,276 |
| **Total Residential Mortgage Banking Activities, Net** | $ 1,329 | $ 42,290 | $ 265 | $ 81,514 |

Income from residential mortgage banking activities, net declined to $1 million during the second quarter of 2014, as compared to $42 million during the second quarter of 2013 and declined to less than $1 million during the first six months of 2014, as compared to $82 million

during the first six months of 2013. The decline in both periods primarily resulted from a timing difference we experienced in the second quarter of 2013, related to our jumbo mortgage pipeline (defined as those loans we have identified for purchase) and the hedging derivatives associated with those loans. At June 30, 2013, we estimated that the net market valuation adjustment associated with loans identified for purchase was approximately negative $34 million, which was not recognized in earnings, whereas the gains from derivatives associated with those loans were included in earnings. The decline in both periods was also attributable to a combination of reduced residential loan acquisition volumes, resulting from higher mortgage rates and lower industry origination volumes, and lower loan sale profit margins. The lower overall profit margins resulted from increased competition, particularly for conforming loans, which have become a larger portion of our overall loan acquisitions during the last two quarters.

In addition, our second quarter 2014 income from mortgage banking activities was impacted by timing differences between the recognition of positive valuation adjustments on certain loans identified for sale (which will potentially be recognized as these loans are purchased in following periods) and the related hedging expenses (which were reflected in our second quarter 2014 results). As of June 30, 2014, we estimated that the net market valuation adjustment associated with loans identified for purchase was approximately positive $9 million.

At June 30, 2014, we had a repurchase reserve of $2.5 million outstanding, of which $606 thousand was recorded in the second quarter of 2014 as a reduction to changes in the fair value of residential loans in Mortgage banking activities, net. During the three months ended June 30, 2014, there were no loan-level repurchase claims made directly to Redwood that were not expected to be recovered from the entity from which we acquired the respective loans. We review our loan repurchase reserves each quarter and will adjust them as necessary based on current information available at each reporting date.

The following table details outstanding principal balances for residential loans held-for-sale by product type at June 30, 2014.

***Table 10 – Characteristics of Unsecuritized Residential Loans***

| **June 30, 2014**<br>**(Dollars In Thousands)** | **Principal Value** | **Weighted Average Coupon** |
|---|---|---|
| **First Lien Prime** | | |
| Fixed - 30 year | $ 813,200 | 4.17% |
| Fixed - 15, 20, & 25 year | 81,718 | 3.49% |
| Hybrid | 178,249 | 3.04% |
| ARM | 2,602 | 2.26% |
| **Total Outstanding Principal** | $ 1,075,769 | 3.93% |

*Operating Expenses and Provision for Income Taxes*

Direct operating expenses attributable to this segment increased to $10 million and $17 million during the three and six months ended June 30, 2014, respectively, from $6 million and $11 million during the three and six months ended June 30, 2013, respectively. The increase in expenses in both periods was attributable to the expansion of our residential mortgage banking operations.

Our residential mortgage banking activities are conducted in a taxable REIT subsidiary and our provision for income taxes is generally correlated to our mortgage banking income. However, the relationship between these two amounts can occasionally change as a result of updates to our estimated annual effective tax rate and changes to income or loss at the taxable REIT subsidiaries. As such, this segment recognized a benefit for income taxes of less than $1 million in the second quarter even though the segment recorded positive GAAP income.

***Residential Investments***

Our residential investments segment is comprised of our residential securities portfolio and MSR investment portfolio. Sequoia IOs that are included as a component of trading securities in our consolidated financial statements are included in our Residential Mortgage Banking segment for reporting purposes. As such, they are excluded from any amounts and tables in this section and such amounts and tables will not agree to amounts presented in our consolidated financial statements for securities.

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The following table presents the components of segment contribution for the residential investments segment for the three and six months ended June 30, 2014 and 2013.

***Table 11 – Residential Investments Segment Contribution***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Interest income | $ 27,924 | $ 24,015 | $ 55,519 | $ 47,533 |
| Interest expense | (3,116) | (2,553) | (5,966) | (5,219) |
| **Net interest income** | 24,808 | 21,462 | 49,553 | 42,314 |
| Other market valuation adjustments, net | (3,788) | (5,738) | (9,746) | (6,308) |
| MSR income (loss), net | (1,777) | 10,547 | (1,171) | 11,568 |
| Realized gains, net | 992 | 526 | 1,979 | 12,564 |
| Direct operating expenses | (770) | (1,956) | (1,865) | (3,539) |
| Benefit from (provision for) income taxes | 149 | (1,236) | 1,676 | (1,661) |
| **Total Segment Contribution** | $ 19,614 | $ 23,605 | $ 40,426 | $ 54,938 |

The following table provides real estate securities activity in our residential investments segment for the three and six months ended June 30, 2014 and 2013.

***Table 12 – Real Estate Securities Activity***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Beginning fair value | $ 1,636,779 | $ 1,175,239 | $ 1,572,356 | $ 1,084,275 |
| Acquisitions | | | | |
| Sequoia securities | 20,428 | 92,368 | 20,428 | 207,096 |
| Third-party securities | 56,493 | - | 130,582 | - |
| Sales | | | | |
| Sequoia securities | - | - | - | - |
| Third-party securities | (1,313) | (192) | (1,313) | (192) |
| Gains on sales and calls, net | 992 | 526 | 1,979 | 526 |
| Effect of principal payments (1) | (51,333) | (37,312) | (90,277) | (73,330) |
| Change in fair value, net | 23,710 | (39,915) | 52,001 | (27,661) |
| **Ending Fair Value** | $ 1,685,756 | $ 1,190,714 | $ 1,685,756 | $ 1,190,714 |

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

The following table provides MSR activity in our residential investments segment for the three and six months ended June 30, 2014 and 2013.

***Table 13 – MSR Activity***

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| | 2014 | | 2013 | 2014 | | 2013 |
| **(In Thousands)** | **Jumbo** | **Conforming** | **Jumbo** | **Jumbo** | **Conforming** | **Jumbo** |
| Beginning fair value | $ 59,208 | $ 5,763 | $ 18,123 | $ 61,493 | $ 3,331 | $ 5,315 |
| Additions | 2,186 | 9,621 | 16,148 | 2,674 | 11,992 | 28,614 |
| Change in fair value, net | (5,356) | (197) | 8,827 | (8,129) | (136) | 9,169 |
| **Ending Fair Value** | $ 56,038 | $ 15,187 | $ 43,098 | $ 56,038 | $ 15,187 | $ 43,098 |

***Residential Securities Portfolio***

During the second quarter of 2014, our residential securities portfolio increased $49 million to $1.69 billion, as we purchased $56 million of third-party securities and retained $20 million of subordinate securities from the Sequoia securitization we completed in April 2014, and received $51 million of principal payments. The third-party securities acquired during the quarter included $51 million of senior securities and $6 million of recently issued third-party subordinate securities.

Net interest income from our securities portfolio increased $3 million to $25 million in the second quarter of 2014 as compared to second quarter of 2013 and increased $7 million to $50 million in the first six months of 2014 as compared to the same period in 2013. Increased net interest income over both the three and six month periods was primarily due to an increase in interest income resulting from higher average earning assets, which increased $469 million from the second quarter of 2013 to $1.5 billion in the second quarter of 2014. The increase in interest income from higher average balances was partially offset by a decline in interest income from lower asset yields, which in the aggregate declined to yields of 7% in the second quarter of 2014 from yields of 9% in the second quarter of 2013. This decrease in yield is primarily attributable to the changing composition of our portfolio as higher yielding legacy senior and subordinate securities purchased in past years pay down and are replaced by new-issue Sequoia and third-party subordinate securities and seasoned third-party senior securities that have lower relative yields.

Interest expense in our residential investments segment increased by $1 million for both the three and six months ended June 30, 2014, primarily due to an increase in average short-term debt balances used to finance the net growth in our securities portfolio. This increase was partially offset by a decline in interest expense on ABS issued as the resecuritization we completed in 2011 continues to pay down.

During the second quarter of 2014, we recognized $12 million of net changes in fair value related to our available-for-sale residential securities portfolio, primarily resulting from declines in interest rates. Of this amount, $264 thousand related to other-than-temporary impairments on securities in an unrealized loss position and was recognized in other market valuation adjustments, net on our income statement. The remaining amount was recognized through accumulated comprehensive income on the balance sheet. In addition, during the second quarter of 2014, other market valuation adjustments included negative $4 million attributable to declines in the value of interest-rate hedging derivatives caused by declining interest rates during the second quarter of 2014. These derivatives are used to manage risks associated with the net interest rate exposure at this segment. This segment includes fixed-rate securities, which increase in value as rates decline, and MSRs, which decrease in value as rates decline. During the second quarter of 2012, the $4 million and $6 million declines in the value of derivatives and MSRs, respectively, were both recognized through earnings, while the $12 million increase in value of securities was recognized through accumulated comprehensive income on our balance sheet.

During the first six months of 2014, we realized $2 million of gains on sold and called securities, as compared to $13 million of gains from the sale of securities during the first six months of 2013. Although we generally intend to hold our investment securities as long-term investments, we may sell certain of these securities to meet operating objectives and to adapt to market conditions. We cannot predict the timing and impact of future sales of investment securities, if any.

In the second quarter of 2014, the benefit for income taxes of less than $1 million in our residential investments segment resulted from GAAP loss recorded at our taxable REIT subsidiaries associated with this segment. As the amount of GAAP income or loss changes at the taxable REIT subsidiaries in future periods, the corresponding provision/benefit for income taxes will generally increase or decrease accordingly.

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The following table provides the activity of our real estate securities by collateral type in our residential investments segment for the three and six months ended June 30, 2014 and 2013.

***Table 14 – Real Estate Securities Activity by Collateral Type***

| **Three Months Ended June 30, 2014 (In Thousands)** | **Senior** | **Re-REMIC (1)** | **Subordinate** | **Total** |
|---|---|---|---|---|
| Beginning fair value | $ 901,511 | $ 192,208 | $ 543,060 | $ 1,636,779 |
| Acquisitions | | | | |
| Sequoia securities | - | - | 20,428 | 20,428 |
| Third-party securities | 50,560 | - | 5,933 | 56,493 |
| Sales | | | | |
| Sequoia securities | - | - | - | - |
| Third-party securities | (1,313) | - | - | (1,313) |
| Gains on sales and calls, net | 992 | - | - | 992 |
| Effect of principal payments (2) | (46,737) | - | (4,596) | (51,333) |
| Change in fair value, net | 7,332 | 388 | 15,990 | 23,710 |
| **Ending Fair Value** | $ 912,345 | $ 192,596 | $ 580,815 | $ 1,685,756 |

| **Six Months Ended June 30, 2014 (In Thousands)** | **Senior** | **Re-REMIC (1)** | **Subordinate** | **Total** |
|---|---|---|---|---|
| Beginning fair value | $ 864,762 | $ 176,376 | $ 531,218 | $ 1,572,356 |
| Acquisitions | | | | |
| Sequoia securities | - | - | 20,428 | 20,428 |
| Third-party securities | 114,449 | 10,200 | 5,933 | 130,582 |
| Sales | | | | |
| Sequoia securities | - | - | - | - |
| Third-party securities | (1,313) | - | - | (1,313) |
| Gains on sales and calls, net | 992 | - | 987 | 1,979 |
| Effect of principal payments (2) | (81,338) | - | (8,939) | (90,277) |
| Change in fair value, net | 14,793 | 6,020 | 31,188 | 52,001 |
| **Ending Fair Value** | $ 912,345 | $ 192,596 | $ 580,815 | $ 1,685,756 |

(1) Re-REMIC securities, as presented herein, were created by third parties through the resecuritization of certain senior interests to provide additional credit support to those interests.
(2) The effect of principal payments reflects the change in fair value due to principal payments, which is calculated as the cash principal received on a given security during the period multiplied by the prior quarter ending price or acquisition price for that security.

At June 30, 2014, the residential securities held (as a percentage of current market value) consisted of fixed-rate assets (41%), adjustable-rate assets (17%), hybrid assets that reset within the next year (36%), and hybrid assets that reset between 12 and 36 months (6%).

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The following table presents real estate securities at June 30, 2014, categorized by portfolio vintage (the years the securities were issued), by priority of cash flows (senior, re-REMIC, and subordinate), and by quality of underlying loans (prime and non-prime).

***Table 15 – Securities by Vintage and as a Percentage of Total Securities (1) (2)***

| June 30, 2014 (Dollars In Thousands) | Sequoia Securities 2012-2014 | Third-party Securities 2005 & Earlier | Third-party Securities 2006 - 2008 | Third-party Securities 2012 - 2014 | Total | % of Total Securities |
|---|---|---|---|---|---|---|
| Senior | | | | | | |
| Prime | $ 2,906 | $ 502,274 | $ 206,530 | $ - | $ 711,710 | 42 % |
| Non-prime | - | 195,972 | 4,664 | - | 200,636 | 12 % |
| Total Senior | 2,906 | 698,246 | 211,194 | - | 912,346 | 54 % |
| Re-REMIC | - | 76,724 | 115,872 | - | 192,596 | 12 % |
| Subordinate | | | | | | |
| Mezzanine (3) | 370,619 | - | - | 54,582 | 425,201 | 25 % |
| Subordinate | 76,338 | 59,593 | 1,272 | 18,410 | 155,613 | 9 % |
| Total Subordinate | 446,957 | 59,593 | 1,272 | 72,992 | 580,814 | 34 % |
| **Total Securities** | $ 449,863 | $ 834,563 | $ 328,338 | $ 72,992 | $ 1,685,756 | 100 % |

(1) Certain totals may not foot, due to rounding.
(2) The securities and interests that we acquired from the Residential Resecuritization entity (which are eliminated for consolidation purposes) were $165 million at June 30, 2014. As a result, to adjust at June 30, 2014, for the legal and economic interests that resulted from the Residential Resecuritization, total residential senior securities would be decreased by $246 million to $666 million, total re-REMIC residential securities would be increased by $165 million to $358 million, and total residential securities would be reduced by $81 million to $1.61 billion.
(3) Mezzanine includes securities initially rated AA, A, and BBB- and issued in 2012 or later.

The following tables present the components of the interest income we earned on AFS securities for the three and six months ended June 30, 2014 and 2013.

***Table 16 – Interest Income — AFS Securities***

**Three Months Ended June 30, 2014**

| (Dollars in Thousands) | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Yield as a Result of Interest Income | Yield as a Result of Discount (Premium) Amortization | Yield as a Result of Total Interest Income |
|---|---|---|---|---|---|---|---|
| **Residential** | | | | | | | |
| Senior | $ 6,957 | $ 6,513 | $ 13,470 | $ 830,565 | 3.35 % | 3.14 % | 6.49 % |
| Re-REMIC | 2,927 | 1,303 | 4,230 | 115,746 | 10.12 % | 4.50 % | 14.62 % |
| Mezzanine (1) | 4,288 | 1,037 | 5,325 | 415,418 | 4.13 % | 1.00 % | 5.13 % |
| Subordinate | 2,290 | 1,733 | 4,023 | 109,430 | 8.37 % | 6.33 % | 14.71 % |
| **Total AFS Securities** | $ 16,462 | $ 10,586 | $ 27,048 | $ 1,471,159 | 4.48 % | 2.88 % | 7.35 % |

**Three Months Ended June 30, 2013**

| (Dollars in Thousands) | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Yield as a Result of Interest Income | Yield as a Result of Discount (Premium) Amortization | Yield as a Result of Total Interest Income |
|---|---|---|---|---|---|---|---|
| **Residential** | | | | | | | |
| Senior | $ 6,689 | $ 4,673 | $ 11,362 | $ 579,333 | 4.62 % | 3.23 % | 7.84 % |
| Re-REMIC | 2,731 | 1,104 | 3,835 | 100,824 | 10.83 % | 4.38 % | 15.21 % |
| Mezzanine (1) | 2,479 | 537 | 3,016 | 239,118 | 4.15 % | 0.90 % | 5.05 % |
| Subordinate | 2,228 | 1,839 | 4,067 | 82,892 | 10.75 % | 8.87 % | 19.63 % |
| **Total AFS Securities** | $ 14,127 | $ 8,153 | $ 22,280 | $ 1,002,167 | 5.64 % | 3.25 % | 8.89 % |

| Six Months Ended June 30, 2014 | | | | | Yield as a Result of | | |
|---|---|---|---|---|---|---|---|
| (Dollars in Thousands) | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Interest Income | Discount (Premium) Amortization | Total Interest Income |
| **Residential** | | | | | | | |
| Senior | $ 13,371 | $ 13,498 | $ 26,869 | $ 806,507 | 3.32 % | 3.35 % | 6.66 % |
| Re-REMIC | 5,443 | 2,883 | 8,326 | 112,766 | 9.65 % | 5.11 % | 14.77 % |
| Mezzanine (1) | 8,418 | 2,034 | 10,452 | 407,321 | 4.13 % | 1.00 % | 5.13 % |
| Subordinate | 4,629 | 3,469 | 8,098 | 107,607 | 8.60 % | 6.45 % | 15.05 % |
| **Total AFS Securities** | $ 31,861 | $ 21,884 | $ 53,745 | $ 1,434,200 | 4.44 % | 3.05 % | 7.49 % |

| Six Months Ended June 30, 2013 | | | | | Yield as a Result of | | |
|---|---|---|---|---|---|---|---|
| (Dollars in Thousands) | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Interest Income | Discount (Premium) Amortization | Total Interest Income |
| **Residential** | | | | | | | |
| Senior | $ 13,726 | $ 9,448 | $ 23,174 | $ 593,096 | 4.63 % | 3.19 % | 7.81 % |
| Re-REMIC | 5,525 | 2,067 | 7,592 | 100,299 | 11.02 % | 4.12 % | 15.14 % |
| Mezzanine (1) | 4,044 | 846 | 4,890 | 192,683 | 4.20 % | 0.88 % | 5.08 % |
| Subordinate | 4,905 | 3,464 | 8,369 | 78,949 | 12.43 % | 8.78 % | 21.20 % |
| **Total AFS Securities** | $ 28,200 | $ 15,825 | $ 44,025 | $ 965,027 | 5.84 % | 3.28 % | 9.12 % |

(1) Mezzanine includes securities initially rated AA, A, and BBB- and issued in 2012 or later.

The following tables present the components of carrying value at June 30, 2014 and December 31, 2013 for our AFS residential securities.

***Table 17 – Carrying Value of AFS Securities***

| June 30, 2014<br>(In Thousands) | Senior | Re-REMIC | Subordinate | Total |
|---|---|---|---|---|
| Principal balance | $ 920,587 | $ 223,389 | $ 717,838 | $ 1,861,814 |
| Credit reserve | (15,173) | (17,788) | (50,315) | (83,276) |
| Unamortized discount, net | (74,150) | (89,089) | (141,054) | (304,293) |
| Amortized cost | 831,264 | 116,512 | 526,469 | 1,474,245 |
| Gross unrealized gains | 74,337 | 76,084 | 54,289 | 204,710 |
| Gross unrealized losses | (1,635) | - | (5,534) | (7,169) |
| **Carrying Value** | $ 903,966 | $ 192,596 | $ 575,224 | $ 1,671,786 |

| December 31, 2013<br>(In Thousands) | Senior | Re-REMIC | Subordinate | Total |
|---|---|---|---|---|
| Principal balance | $ 888,654 | $ 214,046 | $ 706,292 | $ 1,808,992 |
| Credit reserve | (23,984) | (30,429) | (62,457) | (116,870) |
| Unamortized discount, net | (81,015) | (80,188) | (137,266) | (298,469) |
| Amortized cost | 783,655 | 103,429 | 506,569 | 1,393,653 |
| Gross unrealized gains | 73,634 | 72,947 | 41,205 | 187,786 |
| Gross unrealized losses | (1,597) | - | (21,536) | (23,133) |
| **Carrying Value** | $ 855,692 | $ 176,376 | $ 526,238 | $ 1,558,306 |

At June 30, 2014, credit reserves for our AFS securities totaled $83 million, or 4.5% of the principal balance of our residential securities, down from $117 million, or 6.5%, at December 31, 2013. The decrease in the credit reserve primarily resulted from a transfer of credit reserves to accretable unamortized discount during the first six months of 2014, based on sustained improvements in the credit performance of loans underlying our securities that reduced our estimate of future losses on these loans. The accretable

unamortized discount will be recognized into income prospectively over the remaining life of the associated loans. During the three and six months ended June 30, 2014, realized credit losses on our residential securities totaled $4 million and $7 million, respectively. Volatility in income recognition for these securities is generally due to changes in prepayment rates and, to varying degrees, credit performance and interest rates.

*Senior Securities*

The fair value of our senior AFS securities was equal to 98% of their principal balance at June 30, 2014, and the amortized cost was equal to 90% of the principal balance. The fair value of our senior securities accounted for as trading securities in this segment was $14 million. We expect future losses will extinguish a portion of the outstanding principal of these AFS securities, as reflected by the $15 million of credit reserves we have provided for on the $921 million principal balance of those securities.

*Re-REMIC Securities*

Our re-REMIC portfolio consists primarily of prime residential senior securities that were pooled and re-securitized in 2009 and 2010 by third parties to create two-tranche structures. We own support (or subordinate) securities within those structures. The fair value of our re-REMIC AFS securities was equal to 86% of the principal balance of the portfolio at June 30, 2014, while our amortized cost was equal to 52% of the principal balance. We expect future losses will extinguish a portion of the outstanding principal of these securities, as reflected by the $18 million of credit reserves we have provided for on the $223 million principal balance of those securities.

*Subordinate Securities*

The fair value of our subordinate AFS securities was equal to 80% of the principal balance at June 30, 2014, and the amortized cost was equal to 73% of the principal balance. Credit losses totaled $3 million in our residential subordinate portfolio during the second quarter of 2014, as compared to $4 million of losses during the second quarter of 2013. We expect future losses will extinguish a portion of the outstanding principal of these securities, as reflected by the $50 million of credit reserves we have provided for on the $718 million principal balance of those securities.

***MSR Portfolio***

Our MSRs are held and managed at a taxable REIT subsidiary of ours and, typically, are directly acquired from loan originators and recognized through the transfer of loans to a third party or a Sequoia residential securitization sponsored by us that meets the GAAP criteria for sale. Although we retain the rights to service certain loans we securitize or sell, we employ a sub-servicer to perform these activities. Our receipt of MSR income is not subject to any covenants other than customary performance obligations associated with servicing residential loans. For loans that we have transferred into securitizations while maintaining the associated servicing rights, the sub-servicer we contract with to perform servicing activities may be terminated if it fails to perform under the applicable contractual terms. If the sub-servicer is terminated for a breach of contract, a new sub-servicer would need to be approved by the securitization’s master servicer and assume the servicing responsibilities in accordance with the applicable pooling and servicing agreement. If a sub-servicer we contract with was to default, we would evaluate our MSR asset for impairment at that time.

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The following table provides the activity for MSRs by portfolio for the three and six months ended June 30, 2014.

***Table 18 – MSR Activity by Portfolio***

| **Three Months Ended June 30, 2014 (In Thousands)** | **Jumbo** | **Conforming** | **Total MSRs** |
|---|---|---|---|
| Balance at beginning of period | $ 59,208 | $ 5,763 | $ 64,971 |
| MSRs retained from Sequoia securitizations | 2,186 | - | 2,186 |
| MSRs retained from third-party loan sales | - | 7,495 | 7,495 |
| Purchased MSRs | - | 2,126 | 2,126 |
| Market valuation adjustments due to: | | | |
| Changes in assumptions | (3,476) | (77) | (3,553) |
| Other changes (1) | (1,880) | (120) | (2,000) |
| **Balance at End of Period** | $ 56,038 | $ 15,187 | $ 71,225 |
| Loans associated with MSRs (2) | 5,636,623 | 1,449,801 | 7,086,424 |
| MSR values as percent of loans (3) | 0.99% | 1.05% | 1.01% |

| **Six Months Ended June 30, 2014 (In Thousands)** | **Jumbo** | **Conforming** | **Total MSRs** |
|---|---|---|---|
| Balance at beginning of period | $ 61,493 | $ 3,331 | $ 64,824 |
| MSRs retained from Sequoia securitizations | 2,186 | - | 2,186 |
| MSRs retained from third-party loan sales | 488 | 9,302 | 9,790 |
| Purchased MSRs | - | 2,690 | 2,690 |
| Market valuation adjustments due to: | - | - | |
| Changes in assumptions | (3,145) | 217 | (2,928) |
| Other changes (1) | (4,984) | (353) | (5,337) |
| **Balance at End of Period** | $ 56,038 | $ 15,187 | $ 71,225 |
| Loans associated with MSRs (2) | 5,636,623 | 1,449,801 | 7,086,424 |
| MSR values as percent of loans (3) | 0.99% | 1.05% | 1.01% |

(1) Represents changes due to realization of expected cash flows.
(2) Amounts represent the aggregate principal balance of loans associated with MSRs outstanding at June 30, 2014.
(3) Amounts represent the carrying value of MSRs at June 30, 2014 divided by the outstanding balance of the loans associated with these MSRs.

The following table presents the components of MSR income for the three and six months ended June 30, 2014 and 2013.

***Table 19 – MSR Income, Net***

| | **Three Months Ended June 30,** | | **Six Months Ended June 30,** | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Servicing income, net: | | | | |
| Income | $ 4,026 | $ 1,943 | $ 7,624 | $ 2,794 |
| Late charges | 38 | 11 | 73 | 18 |
| Cost of sub-servicer | (288) | (234) | (603) | (412) |
| Net servicing income | 3,776 | 1,720 | 7,094 | 2,400 |
| Market valuation adjustments | (5,553) | 8,827 | (8,265) | 9,168 |
| **(Loss) income from MSRs, Net** | $ (1,777) | $ 10,547 | $ (1,171) | $ 11,568 |

The increase in MSR net servicing income in both the second quarter and the first six months of 2014, compared to the same periods in 2013, was primarily attributable to higher balances of MSRs in 2014 resulting from MSR additions during the past year. The market value declines in the first six months of 2014 were primarily due to a decrease in mortgage interest rates during 2014, which resulted in an increase to the expected prepayment speeds for our jumbo MSRs and a resulting decline in fair value. Market value increases in the first six months of 2013 were primarily attributable to rising mortgage interest rates during that period.

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***Commercial Mortgage Banking and Investments***

The following table presents the components of segment contribution for the commercial mortgage banking and investments segment for the three and six months ended June 30, 2014 and 2013.

***Table 20 – Commercial Mortgage Banking and Investments Segment Contribution***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Interest income | $ 11,217 | $ 9,623 | $ 21,601 | $ 19,794 |
| Interest expense | (4,404) | (2,560) | (7,708) | (5,368) |
| **Net interest income** | 6,813 | 7,063 | 13,893 | 14,426 |
| Provision for loan losses | (289) | (891) | (944) | (1,576) |
| Mortgage banking activities, net | 4,981 | 6,433 | 5,814 | 12,746 |
| Realized gains, net | - | - | - | 210 |
| Direct operating expenses | (2,180) | (2,654) | (4,806) | (5,850) |
| Provision for income taxes | (750) | (495) | (395) | (1,718) |
| **Total Segment Contribution** | $ 8,575 | $ 9,456 | $ 13,562 | $ 18,238 |

The following table provides the activity of commercial loans during the three and six months ended June 30, 2014 and 2013.

***Table 21 – Commercial Loans — Activity***

| | Three Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| **(In Thousands)** | **Held-for-Sale (1)** | **Held-for-Investment** | **Held-for-Sale (1)** | **Held-for-Investment** |
| Balance at beginning of period | $ 77,155 | $ 414,120 | $ 73,780 | $ 327,658 |
| Originations/acquisitions | 148,915 | 5,993 | 149,815 | 18,550 |
| Sales | (180,652) | - | (73,780) | - |
| Principal repayments | (83) | (4,017) | - | (100) |
| Discount amortization | - | 152 | - | 136 |
| Provision for loan losses | - | (289) | - | (891) |
| Changes in fair value, net | 5,513 | 1,959 | (345) | - |
| **Balance at End of Period** | $ 50,848 | $ 417,918 | $ 149,470 | $ 345,353 |

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| **(In Thousands)** | **Held-for-Sale (1)** | **Held-for-Investment** | **Held-for-Sale (1)** | **Held-for-Investment** |
| Balance at beginning of period | $ 89,111 | $ 343,344 | $ 8,500 | $ 304,510 |
| Originations/acquisitions | 237,330 | 38,991 | 303,233 | 54,539 |
| Sales | (245,988) | - | (161,763) | (230) |
| Transfers between portfolios (2) | (37,631) | 37,631 | (155) | - |
| Principal repayments | (170) | (4,301) | - | (12,216) |
| Discount amortization | - | 297 | - | 326 |
| Provision for loan losses | - | (944) | - | (1,576) |
| Changes in fair value, net | 8,196 | 2,900 | (345) | - |
| **Balance at End of Period** | $ 50,848 | $ 417,918 | $ 149,470 | $ 345,353 |

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(1) Beginning in the third quarter of 2013 and through the current period, we elected the fair value option for all senior commercial loans we originated and we anticipate electing the fair value option for all future senior commercial loans that we originate and intend to sell to third parties. All held-for-sale loans outstanding at June 30, 2014, are presented at the lower of cost or fair value.

(2) During the first half of 2014, we sold three senior A-note commercial mortgages to third parties that did not qualify as sales under GAAP, and were not derecognized from our balance sheet. During the first quarter of 2014, these loans and the associated B-note mortgage loans we retained were transferred from held-for-sale to held-for-investment classification and are carried at fair value on our consolidated balance sheets.

At June 30, 2014, we held commercial loans with a total outstanding carrying value of $469 million, consisting of our $418 million held-for-investment portfolio of mostly mezzanine loans as well as $51 million of senior mortgage loans held-for-sale through our mortgage banking operations.

The segment contribution from commercial mortgage banking and investments was consistent in the second quarters of 2014 and 2013 at $9 million and decreased to $14 million in the first six months of 2014, as compared to $18 million in the first six months of 2013. This decrease for the six month period was primarily due to lower income from mortgage banking activities, which resulted from lower senior loan origination volumes and lower loan sale profit margins in the first six months of 2014.

*Commercial Mortgage Banking*

During the first six months of 2014, we originated 22 senior commercial mortgage loans totaling $268 million (inclusive of $31 million of senior loans structured as A/B notes and classified as held-for-investment), as compared to 21 senior commercial loans totaling $303 million that we originated along with another four loans for $146 million that were table-funded (meaning a third party funded and purchased the loan at closing) in the first six months of 2013. At June 30, 2014, there were seven senior loans held-for-sale with a carrying value of $51 million.

Income from mortgage banking activities decreased to $5 million in the second quarter of 2014 from $6 million in the second quarter of 2013 and decreased to $6 million in the first six months of 2014 from $13 million during the first six months of 2013. The decline in mortgage banking income during both periods is primarily due to decreased origination volume, combined with lower loan sale profit margins experienced in 2014 resulting from increased competition. The following table presents the components of commercial mortgage banking activities, net for the three and six months ended June 30, 2014 and 2013.

***Table 22 – Components of Commercial Mortgage Banking Activities, Net[(1)]***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Changes in fair value of: | | | | |
| Commercial loans, at fair value | $ 5,714 | $ (345) | $ 9,340 | $ (345) |
| Risk management derivatives | (815) | 2,924 | (3,619) | 2,059 |
| Other fees | 82 | - | 93 | - |
| Net gains on commercial loan sales and originations | - | 3,854 | - | 11,032 |
| **Total Mortgage Banking Activities, Net** | $ 4,981 | $ 6,433 | $ 5,814 | $ 12,746 |

(1) Amounts reported as net gains on commercial loan sales and originations for 2013 relate to the sale of loans held at the lower of cost or fair value that were purchased or originated to prior to when we began electing the fair value option for commercial loans held-for-sale and represent the net benefit of the gross proceeds from the sale of the loans, less the carrying value of the loans and any related issuance costs. As a result the majority of our income during the first half of 2014 was from loan sales and not from loans that were on our balance sheet at the end of the reporting period.

Our commercial mortgage banking activities are conducted in a taxable REIT subsidiary and our provision for income taxes is generally correlated to our mortgage banking income. However, our estimated effective tax rate is updated each quarter and changes in this rate can affect the correlation between changes in mortgage banking income and tax provision. As such, our provision for income taxes was slightly higher in the second quarter of 2014, compared to the second quarter of 2013, even though mortgage banking income was lower in the second quarter of 2014.

*Commercial Investments*

Our commercial investments portfolio is comprised almost entirely of mezzanine loans and at June 30, 2014, included 56 loans held-for-investment with an outstanding principal balance of $357 million, an unamortized discount of $2 million, an allowance for

loan losses of $8 million, and a carrying value of $347 million. In addition, our held-for-investment portfolio also includes three senior commercial mortgage loans totaling $71 million that were each bifurcated into senior ("A-note") and junior ("B-note") portions. The A-notes were sold during the first six months of 2014, but were not derecognized from our balance sheet as they did not qualify as sales in accordance with GAAP, and rather were treated as secured borrowings. We do not believe we have credit exposure to the A-notes. A-notes that are sold and their associated secured debt are each held at fair value on our consolidated balance sheets and interest income, interest expense and fair value changes associated with these instruments offset each other and have no net impact to our operating results. Our credit exposure related to these investments resides in the associated B-notes that we retained, which totaled $5 million as of June 30, 2014.

During the second quarter of 2014, we originated two mezzanine loans for $6 million as compared to six loans for $19 million in the second quarter of 2013. At June 30, 2014, this portfolio included 29 non-securitized loans with a carrying value of $97 million and 27 loans with a carrying value of $255 million that are included in our Commercial Securitization with $145 million of associated ABS long-term debt.

Net interest income related to our commercial investments was $7 million and $14 million for the three and six months ended June 30, respectively, in both 2014 and 2013. We recognized $1 million of prepayment penalties for a $12 million mezzanine loan that prepaid early in 2013 and $30 thousand of prepayment penalties on $1 million of mezzanine loans that prepaid during the second quarter of 2014.

During the three months ended June 30, 2014 and 2013, we recorded less than $1 million of provisions for loan losses related to the commercial investments portfolio. At June 30, 2014, we had one loan with a carrying value of $26 million (net of allowance for loan losses) on watch list status. This loan is current on all payments and we continue to believe we will receive all amounts in accordance with the contractual terms of the loan. However, in our judgment, certain conditions with this loan warrant closer management attention. Improvements in these conditions would result in the asset being removed from our watch list, whereas deterioration could warrant further downgrades and potential evaluation for impairment. At June 30, 2014, we had no loans designated as impaired and did not have any charge-offs during 2014, which resulted in an allowance for loan losses of $8 million at June 30, 2014. Our allowance for loan losses on our held-for-investment portfolio was $8 million and $7 million at June 30, 2014 and December 31, 2013, respectively, representing 2.3% and 2.1%, respectively, of outstanding loans.

On average, our commercial held-for-investment loans have a maturity of more than five years, an unlevered yield in excess of 10% per annum before credit costs, a loan-to-value ratio of 73% at origination, and a debt service coverage ratio at origination of 1.31x based on our underwritten cash flows. The following table details principal balances and other characteristics for these loans by product type at June 30, 2014.

***Table 23 – Characteristics of Commercial Loans Held-for-Investment at Amortized Cost***

| **June 30, 2014 (Dollars In Thousands)** | **Number of Loans** | **Average Loan Size** | **Principal Balance** | **Percent of Total Principal** | **Weighted Average DSCR (1)** | **Weighted Average LTV (2)** |
|---|---|---|---|---|---|---|
| Multi-family | 25 | $ 9,548 | $ 76,384 | 35% | 1.25 | 79% |
| Hospitality | 9 | 4,976 | 124,397 | 23% | 1.41 | 62% |
| Office | 8 | 8,563 | 51,378 | 22% | 1.36 | 72% |
| Retail | 6 | 6,333 | 19,000 | 14% | 1.16 | 76% |
| Self-storage | 3 | 2,295 | 4,590 | 5% | 1.39 | 75% |
| Industrial | 2 | 9,060 | 81,543 | 1% | 1.37 | 70% |
| **Total** | 53 | $ 6,741 | $ 357,292 | 100% | 1.31 | 73% |

(1) The debt service coverage ratio ("DSCR") is defined as the property's annual net operating income divided by the annual principal and interest payments. The weighted average DSCRs in this table are based on the ratios at the time the loans were originated and are not based on subsequent time periods during which there may have been increases or decreases in each property's operating income.

(2) The loan-to-value ("LTV") calculation is defined as the sum of the senior and all subordinate loan amounts divided by the value of the property at the time the loan was originated.

The following table details principal balances for these loans by geographic concentration at June 30, 2014.

***Table 24 – Geographic Concentration of Commercial Loans Held-for-Investment at Amortized Cost***

| Geographic Concentration (by Principal) | June 30, 2014 |
|---|---|
| California | 20% |
| New York | 19% |
| Florida | 11% |
| Michigan | 7% |
| Texas | 6% |
| Illinois | 6% |
| Other States (none greater than 5%) | 32% |
| **Total** | 100% |

**Results of Legacy Consolidated Entities**

During 2013 and 2014, Legacy Consolidated Entities include certain Sequoia securitization entities issued prior to 2012 that we consolidate for financial reporting purposes. The estimated carrying value of our investments in the Legacy Consolidated Entities was $69 million, or 5% of our equity capital, at June 30, 2014. The carrying value reflects the estimated book value of our retained investments in these entities based on the difference between the consolidated assets and liabilities of the entities in the aggregate according to their GAAP carrying amounts. For the three months ended June 30, 2014, cash flow generated by our investments in these entities totaled $4 million.

To show the impact of the Legacy Consolidated Entities to our consolidated financial results, we have included the following tables that present our consolidated GAAP income statements and balance sheets distributed between Legacy Consolidated Entities and the remainder of our operations, which we refer to as “at Redwood.” Results at Redwood includes all activities from our three business segments and results from assets associated with our Residential Resecuritization completed in 2011 and our Commercial Securitization completed in 2012.

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*Table 25 – Consolidating Income Statement[(1)]*

| (In Millions) | At Redwood | | Legacy Consolidated Entities | | Redwood Consolidated | |
|---|---|---|---|---|---|---|
| | Three Months Ended June 30, | | | | | |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Interest income | $ 52 | $ 49 | $ 6 | $ 9 | $ 58 | $ 58 |
| Interest expense | (16) | (15) | (5) | (7) | (21) | (21) |
| **Net interest income** | 36 | 34 | 1 | 2 | 37 | 36 |
| Reversal of provision (provision) for loan losses | (0) | (1) | 1 | 4 | 0 | 3 |
| **Net interest income after provision** | 35 | 33 | 2 | 6 | 37 | 40 |
| **Noninterest income** | | | | | | |
| Mortgage banking activities, net | 6 | 49 | - | - | 6 | 49 |
| MSR income, net | (2) | 11 | - | - | (2) | 11 |
| Other market valuation adjustments, net | (4) | (6) | - | (1) | (4) | (6) |
| Realized gains, net | 1 | 1 | - | - | 1 | 1 |
| Total noninterest income (loss), net | 2 | 54 | - | (1) | 2 | 54 |
| Operating expenses | (22) | (24) | - | - | (22) | (24) |
| Other expense | - | - | - | - | - | - |
| Net income before provision for taxes | 15 | 63 | 2 | 6 | 17 | 69 |
| Provision for income taxes | (0) | (3) | - | - | (0) | (3) |
| **Net Income** | $ 15 | $ 60 | $ 2 | $ 6 | $ 16 | $ 66 |

| (In Millions) | At Redwood | | Legacy Consolidated Entities | | Redwood Consolidated | |
|---|---|---|---|---|---|---|
| | Six Months Ended June 30, | | | | | |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Interest income | $ 100 | $ 92 | $ 13 | $ 19 | $ 113 | $ 111 |
| Interest expense | (30) | (26) | (11) | (14) | (40) | (40) |
| **Net interest income** | 71 | 67 | 3 | 5 | 73 | 72 |
| Reversal of provision (provision) for loan losses | (1) | (2) | (0) | 3 | (1) | 1 |
| **Net interest income after provision** | 70 | 65 | 3 | 8 | 72 | 73 |
| **Noninterest income** | | | | | | |
| Mortgage banking activities, net | 6 | 94 | - | - | 6 | 94 |
| MSR income, net | (1) | 12 | - | - | (1) | 12 |
| Other market valuation adjustments, net | (10) | (6) | (0) | (0) | (10) | (6) |
| Realized gains, net | 2 | 13 | 0 | 0 | 2 | 13 |
| Total noninterest income (loss), net | (3) | 112 | (0) | (0) | (3) | 112 |
| Operating expenses | (42) | (45) | (0) | (0) | (42) | (45) |
| Other expense | - | - | - | - | - | - |
| Net income before provision for taxes | 25 | 133 | 2 | 7 | 27 | 140 |
| Benefit from (provision for) income taxes | 2 | (14) | - | - | 2 | (14) |
| **Net Income** | $ 26 | $ 119 | $ 2 | $ 7 | $ 28 | $ 126 |

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

*Table 26 – Consolidating Balance Sheet* (1) (2)

| (In Millions) | At Redwood (3) June 30, 2014 | At Redwood (3) December 31, 2013 | Legacy Consolidated Entities (4) June 30, 2014 | Legacy Consolidated Entities (4) December 31, 2013 | Redwood Consolidated June 30, 2014 | Redwood Consolidated December 31, 2013 |
|---|---|---|---|---|---|---|
| Residential loans | $ 1,108 | $ 404 | $ 1,617 | $ 1,762 | $ 2,724 | $ 2,166 |
| Commercial loans | 469 | 432 | - | - | 469 | 432 |
| Real estate securities, at fair value: | 1,845 | 1,683 | - | - | 1,845 | 1,683 |
| MSRs, at fair value | 71 | 65 | - | - | 71 | 65 |
| Cash and cash equivalents | 157 | 173 | - | - | 157 | 173 |
| Total earning assets | 3,650 | 2,758 | 1,617 | 1,762 | 5,267 | 4,520 |
| Other assets | 105 | 81 | 7 | 8 | 112 | 89 |
| **Total Assets** | $ 3,755 | $ 2,838 | $ 1,623 | $ 1,770 | $ 5,379 | $ 4,609 |
| Short-term debt | $ 1,719 | $ 863 | $ - | $ - | $ 1,719 | $ 863 |
| Other liabilities | 95 | 79 | 1 | 1 | 97 | 81 |
| Asset-backed securities issued | 214 | 249 | 1,554 | 1,694 | 1,768 | 1,943 |
| Long-term debt | 547 | 476 | - | - | 547 | 476 |
| Total liabilities | 2,575 | 1,667 | 1,555 | 1,696 | 4,130 | 3,363 |
| Stockholders' equity | 1,180 | 1,171 | 69 | 75 | 1,248 | 1,246 |
| **Total Liabilities and Equity** | $ 3,755 | $ 2,838 | $ 1,623 | $ 1,770 | $ 5,379 | $ 4,609 |

(1) We are required under GAAP to consolidate the assets and liabilities of certain securitization entities we have sponsored for financial reporting purposes. However, the securitized assets of these entities are not legally ours and we own only the securities and interests that we acquired from these securitization entities. Similarly, the liabilities of these entities are obligations payable only from the cash flow generated by their securitized assets and are not obligations of Redwood.

(2) Certain totals may not foot, due to rounding.

(3) Included in the "At Redwood" column are the assets and liabilities of the Residential Resecuritization and Commercial Securitization transactions we completed in 2011 and 2012, respectively. These transactions are treated as secured borrowings under GAAP. At June 30, 2014, the Residential Resecuritization accounted for $247 million of assets ($246 million of available-for-sale securities and $1 million of other assets) and $70 million of asset-backed securities issued. Our $177 million investment in this resecuritization, as estimated for GAAP, equals the difference between these assets and liabilities. At June 30, 2014, the Commercial Securitization accounted for $257 million of assets ($255 million of commercial loans at historical cost and $2 million of other assets) and $145 million of asset-backed securities issued (at amortized cost). Our $113 million investment in this securitization, as estimated for GAAP, equals the difference between these assets and liabilities.

(4) Legacy Consolidated Entities includes certain Sequoia securitizations completed prior to 2012 that we are required to consolidate under GAAP. Our estimated GAAP investment in these entities was $69 million at June 30, 2014, representing the difference between the aggregate carrying value of assets and liabilities of these entities.

***Net Interest Income at Legacy Consolidated Entities***

Net interest income from Legacy Consolidated Entities was $1 million and $2 million for the three months ended June 30, 2014 and 2013, respectively, and was $3 million and $5 million for the six months ended June, 30 2014 and 2013, respectively. The decreases year-over-year are primarily attributable to continued principal paydowns of assets at these entities. Net interest income at Legacy Consolidated Entities will vary from period to period and depend primarily on the rate of principal repayments on loans and changes in the levels of delinquencies associated with consolidated loans. As the loans and associated liabilities pay down, net interest income will decline over time.

***Loan Loss Provision at Legacy Consolidated Entities***

Each quarter we utilize a loan loss reserving methodology that has been established to provide management with a reasonable and adequate estimate of loan loss reserving needs. This methodology is disclosed in Note 3 and Note 6 to the financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

The reversal of provision for loan losses at Legacy Consolidated Entities was less than $1 million during the second quarter of 2014, as compared to $4 million in the second quarter of 2013. The provision for loan losses was greater than the net charge-offs of less than $1 million (or 0.03% of outstanding loan balances) for the second quarter of 2014, and the provision for loan losses was greater than the net charge-offs of $2 million (or 0.06% of outstanding loan balances) for the second quarter of 2013. This resulted in a decrease of $2 million and $6 million in our allowance for loan losses for the three months ended June 30, 2014 and 2013, respectively. Charge-offs resulted from $6 million and $5 million of defaulted loan principal for the second quarters of 2014 and 2013, for average implied loss severities of 15% and 32%, respectively.

The allowance for loan losses increased to $24 million (or 1.47% of outstanding residential loans held-for-investment balances) at June 30, 2014, from $23 million (or 1.16% of outstanding residential loans held-for-investment balances) at June 30, 2013. Serious delinquencies on loans held at Consolidated Sequoia Entities (90+ days delinquent) increased to $74 million (or 4.56% of outstanding loan balances) at June 30, 2014, from $65 million (or 3.27% of outstanding loan balances) at June 30, 2013. Loans originated in Florida, Georgia, New Jersey, and Pennsylvania accounted for 24% of total loans and 40% of the serious delinquent loan balance held by Sequoia entities at June 30, 2014.

At June 30, 2014, we estimate that there were three legacy Consolidated Sequoia Entities for which the carrying value of the entity's liabilities exceeded the corresponding carrying value of the entity's assets. This is primarily attributable to the continued building of loan loss allowances in accordance with GAAP, resulting in lower asset carrying values. The aggregate estimated net assets (or equity) at these consolidated entities were less than negative $1 million at June 30, 2014, an amount we expect to reverse through positive adjustments to earnings in future periods as the entities are retired or deconsolidated for financial reporting purposes.

***Real Estate Loans at Legacy Consolidated Entities***

The following table provides details of residential loan activity at Legacy Consolidated Entities for the three and six months ended June 30, 2014 and 2013.

***Table 27 – Residential Loans at Legacy Consolidated Entities — Activity***

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(In Thousands)** | **2014** | **2013** | **2014** | **2013** |
| Balance at beginning of period | $ 1,689,994 | $ 2,133,254 | $ 1,762,168 | $ 2,272,812 |
| Principal repayments | (71,903) | (136,179) | (142,553) | (272,153) |
| Charge-offs, net | 994 | 1,751 | 1,478 | 2,545 |
| Premium amortization | (1,092) | (1,765) | (2,205) | (3,463) |
| Transfers to REO | (2,094) | (3,046) | (2,361) | (4,372) |
| Reversal of provision (provision) for loan losses | 605 | 4,163 | (23) | 2,809 |
| **Balance at End of Period** | $ 1,616,504 | $ 1,998,178 | $ 1,616,504 | $ 1,998,178 |

***Loan Characteristics***

The following table highlights unpaid principal balances for loans at legacy Consolidated Sequoia Entities by product type at June 30, 2014. First lien adjustable rate mortgage (ARM) and hybrid loans comprise 91% of the consolidated portfolio and were primarily originated in 2005 or prior. Conversely, fixed-rate loans, which make up 8% of the portfolio, were primarily originated in 2009 or later. Of the $51 million of hybrid loans held at legacy consolidated Sequoia securitization entities at June 30, 2014, $30 million (or 59%) had reset as of June 30, 2014, and now act as ARM loans.

***Table 28 – Loan Characteristics at Legacy Consolidated Entities***

| **June 30, 2014**<br>**(Dollars In Thousands)** | | **Principal Balance** | **Percent of Total** |
|---|---|---|---|
| First Lien | | | |
| ARM | $ | 1,423,617 | 87.56% |
| Fixed | | 137,298 | 8.44% |
| Hybrid (years to reset) | | | |
| Reset | | 30,456 | 1.87% |
| 0-4 | | 6,764 | 0.42% |
| 5-8 | | 14,138 | 0.87% |
| Second Lien | | | |
| ARM | | 13,617 | 0.84% |
| **Total Outstanding Principal** | $ | 1,625,890 | 100.00% |

For outstanding loans at legacy Consolidated Sequoia Entities at June 30, 2014, the weighted average FICO score (at origination) of borrowers backing these loans was 733 and the weighted average original LTV ratio was 66%.

The majority of hybrid loans and all of the fixed rate loans at the legacy consolidated Sequoia entities were securitized during 2010 and 2011. At June 30, 2014, fixed-rate loans had a weighted average coupon of 4.63%, ARM loans had a weighted average coupon of 1.60%, and hybrid loans had a weighted average coupon of 3.48%.

**Taxable Income**

The following table summarizes our taxable income (loss) and distributions to shareholders for the three and six months ended June 30, 2014 and 2013. For each of these periods, we had no undistributed REIT taxable income.

***Table 29 – Taxable Income***

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| **(In Thousands)** | **2014 est. (1)** | | **2013 est. (1)** | | **2014 est. (1)** | | **2013 est. (1)** | |
| REIT taxable income | $ | 14,203 | $ | 20,249 | $ | 29,665 | $ | 36,309 |
| Taxable REIT subsidiary (loss) income | | 507 | | (50,019) | | (3,746) | | (7,399) |
| **Total Taxable Income (Loss)** | $ | 14,710 | $ | (29,770) | $ | 25,919 | $ | 28,910 |
| Distributions to shareholders | $ | 23,232 | $ | 22,995 | $ | 46,342 | $ | 45,870 |

(1) Our tax results for 2014 and 2013 are estimates until we file tax returns for these years.

Our estimated total taxable income for the three months ended June 30, 2014, was $15 million ($0.17 per share) and included $1 million in realized credit losses on investments. This compared to taxable loss for the three months ended June 30, 2013, of $30 million ($0.36 per share) that included $2 million in realized credit losses. For the three months ended June 30, 2014, we realized net capital gains of $1 million at the REIT for tax purposes.

Our estimated total taxable income for the six months ended June 30, 2014, was $26 million ($0.31 per share) and included $4 million in realized credit losses on investments. This compared to taxable income for the six months ended June 30, 2013, of $29 million ($0.36 per share) that included $7 million in realized credit losses. For the six months ended June 30, 2014, we realized net capital gains of $1 million at the REIT for tax purposes.

For the three and six months ended June 30, 2014, we recorded a tax provision of less than $1 million and a benefit for income taxes of $2 million, respectively. Our tax provisions relate to GAAP income earned at our TRS. We are currently benefiting from favorable timing differences between when income associated with our mortgage banking activities is recognized for GAAP purposes versus when it is recognized for tax purposes, thus deferring a significant portion of the tax liability on that income. The mortgage banking income is not expected to be excess inclusion income, was not earned at the REIT, and will not affect the tax characterization of our 2014 dividends. We did not record a material tax provision associated with taxable income generated at our REIT.

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

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

The tables below reconcile our estimated total taxable income to our GAAP income for the three and six months ended June 30, 2014 and 2013.

***Table 30 – Differences between Estimated Total Taxable Income and GAAP Net Income***

| | Three Months Ended June 30, 2014 | | |
|---|---|---|---|
| **(In Thousands, Except per Share Data)** | **Tax (Est.)** | **GAAP** | **Differences** |
| Interest income | $ 48,419 | $ 57,993 | $ (9,574) |
| Interest expense | (19,430) | (21,151) | 1,721 |
| Net interest income | 28,989 | 36,842 | (7,853) |
| Reversal of provision for loan losses | - | 315 | (315) |
| Realized credit losses | (1,087) | - | (1,087) |
| Mortgage banking activities, net | 5,845 | 6,310 | (465) |
| MSR income, net | 3,653 | (1,777) | 5,430 |
| Other market valuation adjustments, net | - | (4,121) | 4,121 |
| Operating expenses | (22,657) | (22,282) | (375) |
| Realized gains, net | - | 1,063 | (1,063) |
| Benefit from (provision for) income taxes | (33) | (333) | 300 |
| **Net Income** | $ 14,710 | $ 16,017 | $ (1,307) |
| Income per share | $ 0.17 | $ 0.18 | $ (0.01) |

| (In Thousands, Except per Share Data) | Three Months Ended June 30, 2013 | | |
|---|---|---|---|
| | Tax | GAAP | Differences |
| Interest income | $ 53,434 | $ 57,719 | $ (4,285) |
| Interest expense | (15,026) | (21,416) | 6,390 |
| Net interest income | 38,408 | 36,303 | 2,105 |
| Reversal of provision for loan losses | - | 3,272 | (3,272) |
| Realized credit losses | (2,026) | - | (2,026) |
| Mortgage banking activities, net | (47,866) | 48,723 | (96,589) |
| MSR income, net | 1,720 | 10,547 | (8,827) |
| Other market valuation adjustments, net | - | (6,258) | 6,258 |
| Operating expenses | (19,815) | (24,429) | 4,614 |
| Realized gains, net | - | 556 | (556) |
| Provision for income taxes | (191) | (3,140) | 2,949 |
| **Net Income (Loss)** | $(29,770) | $ 65,573 | $ (95,343) |
| Income per share | $ (0.36) | $ 0.71 | $ (1.07) |

| (In Thousands, Except per Share Data) | Six Months Ended June 30, 2014 | | |
|---|---|---|---|
| | Tax (Est.) | GAAP | Differences |
| Interest income | $ 95,295 | $113,469 | $ (18,174) |
| Interest expense | (38,412) | (40,211) | 1,799 |
| Net interest income | 56,883 | 73,258 | (16,375) |
| Provision for loan losses | - | (967) | 967 |
| Realized credit losses | (4,103) | - | (4,103) |
| Mortgage banking activities, net | 8,166 | 6,079 | 2,087 |
| MSR income, net | 6,874 | (1,171) | 8,045 |
| Other market valuation adjustments, net | - | (10,260) | 10,260 |
| Operating expenses | (41,836) | (42,254) | 418 |
| Realized gains, net | - | 2,155 | (2,155) |
| Benefit from (provision for) income taxes | (65) | 1,510 | (1,575) |
| **Net Income** | $ 25,919 | $ 28,350 | $ (2,431) |
| Income per share | $ 0.31 | $ 0.32 | $ (0.01) |

| (In Thousands, Except per Share Data) | Six Months Ended June 30, 2013 | | |
|---|---|---|---|
| | Tax | GAAP | Differences |
| Interest income | $101,665 | $111,243 | $ (9,578) |
| Interest expense | (26,067) | (39,718) | 13,651 |
| Net interest income | 75,598 | 71,525 | 4,073 |
| Reversal of provision for loan losses | - | 1,233 | (1,233) |
| Realized credit losses | (6,695) | - | (6,695) |
| Mortgage banking activities, net | (4,427) | 94,260 | (98,687) |
| MSR income, net | 2,400 | 11,568 | (9,168) |
| Other market valuation adjustments, net | - | (6,561) | 6,561 |
| Operating expenses | (37,727) | (44,616) | 6,889 |
| Realized gains, net | - | 12,823 | (12,823) |
| Provision for income taxes | (239) | (14,049) | 13,810 |
| **Net Income** | $ 28,910 | $126,183 | $ (97,273) |
| Income per share | $ 0.36 | $ 1.40 | $ (1.04) |

**Potential Taxable Income Volatility**

We expect period-to-period estimated taxable income volatility for a variety of reasons, including those described below.

***Credit Losses on Securities and Loans***

To determine estimated taxable income, we are generally not permitted to anticipate, or reserve for, credit losses on investments which are generally purchased at a discount. For tax purposes, we accrue the entire purchase discount on a security into taxable income over the expected life of the security. Estimated taxable income is reduced when actual credit losses occur. For GAAP purposes, we establish a credit reserve and only accrete a portion of the purchase discount, if any, into income and write-down securities that become impaired. Our income recognition is therefore faster for tax as compared to GAAP, especially in the early years of owning a security (when there are generally few credit losses). At June 30, 2014, the cumulative difference between the GAAP and tax amortized cost basis of our residential securities (excluding our investments in our consolidated securitization entities and IO securities) was $26 million.

As we have no credit reserves or allowances for tax, any future credit losses on securities or loans will have a more significant impact on tax earnings than on GAAP earnings and may create significant taxable income volatility to the extent the level of credit losses fluctuates during reporting periods. During the three months ended June 30, 2014, and 2013, we realized $1 million and $2 million, respectively, of credit losses on securities for tax that we had previously provisioned for under GAAP. We anticipate that credit losses will continue to be a significant, but declining, factor for determining taxable income. Credit losses are based on our tax basis, which differs materially from our basis for GAAP purposes. We anticipate an additional $40 million of credit losses for tax on securities, based on our projection of principal balance losses and assuming a similar tax basis as we have recently experienced, although the timing of actual losses is difficult to accurately project. At June 30, 2014, for GAAP we had a designated credit reserve of $83 million on our securities, and an allowance for loan losses of $32 million for our consolidated residential and commercial loans.

***Recognition of Gains and Losses on Sale***

Since the computation of amortization and impairments on assets may differ for tax and GAAP, the tax and GAAP basis on assets sold or called may differ, resulting in differences in gains and losses on sale or call. In addition, gains realized for tax may be offset by prior capital losses and, thus, not affect taxable income. At June 30, 2014, the REIT had an estimated $294 million in federal capital loss carryforwards ($3.54 per share) that can be used to offset future capital gains over the next one to four years. Since our intention is to generally make long-term investments, it is difficult to anticipate when sales may occur and, thus, when or whether we might exhaust these capital loss carryforwards. At June 30, 2014, we had an estimated $22 million in federal capital loss carryforwards at the TRS level. We anticipate selling most of our portfolio of appreciated IO securities within the capital loss carryforward period. Consequently, it is likely that the TRS will benefit from the use of the capital loss carryforwards.

***Prepayments on Securities***

We have retained certain IO securities at the time they were issued from Sequoia securitizations we have sponsored. Our tax basis in these securities was $80 million at June 30, 2014, which includes a tax basis of $70 million for IOs retained from securitizations completed in 2010 and later. The return on IOs is sensitive to prepayments and, to the extent prepayments vary period to period, income from these IOs will vary. Typically, fast prepayments reduce yields and slow prepayments increase yields. We are not permitted to recognize a negative yield under tax accounting rules, so during periods of fast prepayments our periodic premium expense for tax purposes can be relatively low and the tax cost basis for these securities may not be significantly reduced. In periods prior to 2008, we experienced fast prepayments on the loans underlying our IOs. More recently, prepayments on loans owned at Consolidated Sequoia Entities issued prior to 2010 have been slow, and our tax basis is now below the fair values for these IOs in the aggregate. If a Sequoia securitization is called, the remaining tax basis in the IO is expensed, creating an ordinary loss at the call date.

Prepayments also affect the taxable income recognition on other securities we own. We are required to use particular prepayment assumptions for the remaining lives of each security. As actual prepayment speeds vary, the yield we recognize for tax purposes will be adjusted accordingly. Thus, to the extent prepayments differ from our long-term assumptions or vary from period to period, the yield recognized will also vary and this difference could be material for a specific security.

***Compensation Expense***

The total tax expense for equity award compensation is dependent upon varying factors such as the timing of payments of dividend equivalent rights, the exercise of stock options, the distribution of deferred stock units and preferred stock units, and the cash deferrals to and withdrawals from our Executive Deferred Compensation Plan. For GAAP purposes, the total expense associated with an equity award is determined at the award date and is recognized over the vesting period. For tax, the total expense is recognized at the date of distribution or exercise, not the award date. In addition, some compensation may not be deductible for tax if it exceeds certain levels and is not performance-based. Thus, the total amount of compensation expense, as well as the timing, could be significantly different for tax than for GAAP.

As an example, for GAAP we expense the grant date fair value of performance stock units ("PSUs") granted over the vesting term of those PSUs (regardless of the degree to which the performance conditions for vesting are ultimately satisfied, if at all), whereas for tax the value of the PSUs that actually vest in accordance with the performance conditions of those awards and are subsequently distributed to the award recipient is recorded as an expense on the date of distribution. For example, if no PSUs under a particular grant ultimately vest, due to the failure to satisfy the performance conditions, no tax expense will be recorded for those PSUs, even though we would have already recorded expense for GAAP equal to the grant date fair value of the PSU awards. Conversely, for example, if performance is such that a number of shares of common stock equal to 200% of the PSU award ultimately vest and are delivered to the award recipient, expense for tax will equal the common stock value on the date of distribution of 200% of the number of PSUs originally granted. This expense for tax could significantly exceed the recorded expense for GAAP.

In addition, since the decision to exercise options or distribute deferred stock units, performance stock units, or cash out of the Executive Deferred Compensation Plan is an employee's, it can be difficult to project when the tax expense will occur.

***Mortgage Servicing Rights***

For GAAP purposes, we recognize MSRs through the acquisition of servicing rights from third parties or through the retention of MSRs associated with residential loans that we have acquired and subsequently transferred to non-consolidated securitization entities or to third parties. For tax purposes, basis in our MSR assets is recognized through the acquisition of servicing rights from third parties, or to the extent that the MSR entitles us to receive a servicing fee that is in excess of a safe harbor amount prescribed by the Internal Revenue Service. Tax basis in our MSR assets is not recognized when MSRs are retained from transfers of loans to non-consolidated securitization entities or to third parties thereby creating a temporary GAAP to tax difference on the gain from sale. For the six months ended June 30, 2014, we purchased $2 million of MSRs on conforming loans that were recognized for tax purposes. No other tax basis in our MSR assets has been recognized to date.

For GAAP purposes, mortgage servicing fee income, net of servicing expense and changes in the estimated fair value of our MSRs, is recognized on our consolidated income statement over the life of the MSR asset. For tax purposes, only mortgage servicing fee income, net of servicing expense is recognized as taxable income. Any MSR where basis is recognized for tax purposes through acquisition is amortized as a tax expense over a finite life.

## LIQUIDITY AND CAPITAL RESOURCES

### Summary

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

While we had previously expected our available capital and liquidity to be sufficient to fund our business and investment objectives for most of 2014, as a result of improving market conditions, our rate of capital deployment in the second half of 2014 may require us to source additional capital prior to the end of the year. As we have stated in the past, we look first to our own balance sheet for attractive opportunities to raise capital through sales or financings of assets before we look externally. Since the end of the second quarter of 2014, we sold $224 million of securities, increasing our available capital by $20 million at July 31, 2014. Should we decide we need to raise additional external capital to fund our business activities, we would consider the issuance of convertible debt securities under the shelf registration statement we currently have on file with the SEC, as well as the issuance of common equity, other debt securities, or similar or other types of securities in public or private offerings.

At June 30, 2014, we held $157 million in cash, and our investment capacity (defined as the approximate amount of capital we had readily available for long-term investments) was estimated to be approximately $62 million. Total capital of $1.7 billion at June 30, 2014, included $1.2 billion of equity capital, $140 million of long-term debt, and $288 million of long-term convertible debt.

In the ordinary course of our business, we use short-term recourse debt through several different types of borrowing facilities and use cash borrowings under these facilities to, among other things, fund the acquisition of residential loans and the origination of commercial loans (including those we acquire and originate in anticipation of securitization), finance investments in securities and other investments, and otherwise fund our business and operations. At June 30, 2014, we had five residential loan warehouse facilities with a total outstanding debt balance of $852 million (secured by residential loans with an aggregate fair value of $954 million) and a total borrowing limit of $1.40 billion. We also had, at June 30, 2014, a $100 million short-term commercial loan warehouse facility with a total outstanding debt balance of $12 million (secured by commercial loans with an aggregate fair value of $17 million) and a long-term commercial loan warehouse facility with an outstanding balance of $53 million and a total borrowing limit of $150 million. In addition, at June 30, 2014, we had an aggregate outstanding short-term debt balance of $854 million under nine securities repurchase facilities, which were secured by securities with a fair market value of $1.03 billion. We also had a secured line of credit with no outstanding debt balance and a total borrowing limit of $10 million (secured by securities with a fair market value in excess of $10 million) at June 30, 2014.

At June 30, 2014, we had $1.72 billion of short-term debt outstanding. For the second quarter of 2014, the highest balance of our short-term debt outstanding was $1.72 billion.

We are subject to risks relating to our liquidity and capital resources, including risks relating to incurring short-term debt under residential and commercial loan warehouse facilities, securities repurchase facilities, and other short-term debt facilities and other risks relating to our use of derivatives. A further discussion of these risks is set forth below under the heading "*Risks Relating to Short-Term Debt Incurred Under Residential Mortgage Loan Warehouse Facilities, Securities Repurchase Facilities, and Other Short-Term Debt Facilities; and Risks Relating to Debt Incurred Under Commercial Debt Investment Repurchase Facilities*" below in this Quarterly Report on Form 10-Q.

**Cash Flows and Liquidity for the Six Months Ended June 30, 2014**

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

***Cash Flows from Operating Activities***

Cash flows from operating activities were negative $786 million in the first six months of 2014. This amount was negative primarily due to the inclusion of the net cash utilized during the period from the purchase and sale of residential and commercial mortgage loans associated with our mortgage banking activities. Purchases of loans are financed to a large extent with short-term debt, for which changes in cash are included as a component of financing activities. Additionally, net cash utilized from the purchase and sale of loans during the first six months of 2014 partially results from a timing difference as we had $1.16 billion of residential and commercial loans held-for-sale at June 30, 2014. Excluding cash flows from the purchase and sale of loans, cash flows from operating activities were negative $7 million in the first six months of 2014.

***Cash Flows from Investing Activities***

Although we generally intend to hold our investment securities as long-term investments, we may sell certain of these securities in order to manage our interest rate risk and liquidity needs, to meet other operating objectives, and to adapt to market conditions. We cannot predict the timing and impact of future sales of investment securities, if any. Because many of our investment securities are financed through repurchase agreements, a significant portion of the proceeds from any sales of our investment securities would generally be used to repay balances under these financing sources. Similarly, all or a significant portion of cash flows from prepayments and scheduled amortization in respect of our investment securities would also generally be used to repay balances under these financing sources.

***Cash Flows from Financing Activities***

During the six months ended June 30, 2014, we paid $48 million of cash dividends on our common stock, representing a dividend of $0.28 per share per quarter. In accordance with the terms of outstanding deferred stock units, which are stock-based compensation awards, each time we declare and pay a dividend on our common stock, we are required to make a dividend equivalent payment in that same per share amount on each outstanding deferred stock unit.

In November 2013, our Board of Directors announced its intention to pay a regular dividend of $0.28 per share per quarter in 2014. Our regular quarterly dividend rate is determined by our Board of Directors. Our Board's practice has been to announce its intention with respect to the regular quarterly dividend for the upcoming calendar year towards the end of the fourth quarter of each year. The consistency and sustainability of the dividend over time has always been an important consideration and priority. In recent years, the quarterly dividend rate has not been directly tied to GAAP or REIT taxable earnings for any particular quarter. In addition, in deliberating about dividends, the Board has generally considered numerous factors, including management's projections for the company's GAAP and REIT taxable earnings, and also projections of cash flows, capital, and liquidity. For example, in 2011, no change to the dividend rate was made, even though our earnings were lower than the quarterly dividend, as we invested in building our residential and commercial platforms.

During 2013, we issued $287.5 million of convertible senior notes, as described in the long-term debt section that follows.

**Long-Term Debt**

***Commercial Borrowings***

At June 30, 2014, we had one commercial loan warehouse facility with an outstanding balance of $53 million and a total borrowing limit of $150 million.

***Commercial Secured Borrowings***

At June 30, 2014, we had commercial secured borrowings of $67 million resulting from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. We structured certain of our senior commercial mortgage loans into a senior portion that was sold to a third party and a junior portion that we retained as an investment. Although GAAP requires us to record a secured borrowing liability when we receive cash from selling the senior portion of the loan, the liability has no economic substance to us in that it does not require periodic interest payments and has no maturity. For each commercial secured borrowing, at such time that the associated senior portion of the loan is repaid or we sell our retained junior portion, the secured borrowing liability and associated senior portion of the loan would be derecognized from our balance sheet.

***Convertible Notes***

In March 2013, we issued $287.5 million principal amount of 4.625% convertible senior notes that are convertible into 41.1320 shares of common stock per $1,000 principal amount (equivalent to a conversion price of $24.31 per common share and subject to certain adjustments) on or before their maturity in April 2018. After deducting the underwriting discount and issuance costs, we received approximately $279 million of net proceeds. Including amortization of deferred issuance costs, the interest expense yield on our convertibles notes was 5.44% and 5.42% for the three and six months ended June 30, 2014, respectively. At June 30, 2014, the accrued interest payable balance on this debt was $3 million.

***Trust Preferred Securities and Subordinated Notes***

At June 30, 2014, we had trust preferred securities and subordinated notes of $100 million and $40 million, respectively issued by us in 2006 and 2007. This debt requires quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole. Beginning in the first quarter of 2011, we entered into interest rate swaps with aggregate notional values currently totaling $140 million to hedge the variability in this long-term debt interest expense, fixing our gross interest expense yield at 6.75%. These swaps are accounted for as cash flow hedges with all interest income recorded as a component of net interest income and other valuation changes recorded as a component of equity.

***Asset-Backed Securities***

In July 2011, Redwood transferred $365 million of residential securities into the Residential Resecuritization in connection with the issuance of $245 million of ABS by the Residential Resecuritization to third parties. At June 30, 2014, there were $246 million of securities owned at the Residential Resecuritization, which were funded with $70 million of ABS issued.

In November 2012, Redwood transferred $291 million (principal balance) of commercial loans into the Commercial Securitization in connection with the issuance of $172 million of ABS by the Commercial Securitization to third parties. At June 30, 2014, there were $255 million (carrying value) of commercial loans owned at the Commercial Securitization, which were funded with $145 million of ABS issued.

At June 30, 2014, there were $1.62 billion of loans owned at Sequoia securitization entities (Legacy Consolidated Entities), which were funded with $1.55 billion of ABS issued at these entities. The loans and ABS issued from these entities are reported at their unpaid principal balances net of any unamortized premium or discount.

**Risks Relating to Short-Term Debt Incurred Under Residential Mortgage Loan Warehouse Facilities, Securities Repurchase Facilities, and Other Short-Term Debt Facilities; and Risks Relating to Debt Incurred Under Commercial Debt Investment Repurchase Facilities**

As described above under the heading "*Results of Operations*," in the ordinary course of our business, we use debt financing obtained through several different types of borrowing facilities to, among other things, finance the acquisition of residential mortgage loans we acquire (including those we acquire in anticipation of sale or securitization), finance commercial mortgage loans we originate (including those we originate in anticipation of sale or securitization), finance the other commercial debt investments we originate and acquire, and finance investments in securities and other investments. We may also use short-term borrowings to fund other aspects of our business and operations.

*Residential Loan Warehouse Facilities*. One source of our short-term debt financing is secured borrowings under residential loan warehouse facilities that are in place with five different financial institution counterparties. Under these five warehouse facilities, we had an aggregate borrowing limit of $1.4 billion at June 30, 2014; however, these facilities are uncommitted, which means that any request we make to borrow funds under these facilities may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under these facilities. Short-term financing for residential mortgage loans is obtained under these facilities by our transfer of mortgage loans to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred mortgage loans), and our covenant to reacquire those loans from the counterparty for the same amount plus a financing charge.

In order to obtain financing for a residential loan under these facilities, the loan must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the loan is not in a delinquent status.

In addition, under these warehouse facilities, residential loans can only be financed for a maximum period, which period would not generally exceed 364 days. We generally intend to repay the short-term financing of a loan under one of these facilities at or prior to the expiration of that financing with the proceeds of a securitization or other sale of that loan, through the proceeds of other short-term borrowings, or with other equity or long-term debt capital. While a residential loan is financed under a warehouse facility, to the extent the market value of the loan declines (which market value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the loan or meet a margin requirement to pledge additional collateral, such as cash or additional residential loans, in an amount at least equal to the decline in value. See further discussion below under the heading "*–Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*"

Because these warehouse facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*." In addition, with respect to residential loans that at any given time are already being financed through these warehouse facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*," if and when those loans become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the applicable facility.

Under our residential loan warehouse facilities, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under these facilities and these facilities being unavailable to use for future financing needs. In particular, the terms of these facilities include financial covenants, cross-default provisions, judgment default provisions, and other events of default (such as, for example, events of default triggered by one of the following: a change in control over Redwood, regulatory investigation or enforcement action against Redwood, Redwood's failure to continue to qualify as a REIT for tax purposes, or Redwood's failure to maintain the listing of its common stock on the New York Stock Exchange). Under a cross-default provision, an event of default is triggered (and the warehouse facility becomes unavailable and outstanding amounts borrowed thereunder become due and payable) if an event of default or similar event occurs under another borrowing or credit facility we maintain in excess of a specified amount. Under a judgment default provision, an event of default is triggered (and the warehouse facility becomes unavailable and outstanding amounts borrowed thereunder become due and payable) if a judgment for damages in excess of a specified amount is entered against us in any litigation and we are unable to promptly satisfy the judgment. Financial covenants included in these warehouse facilities are further described below under the heading "*–Financial Covenants Associated with Short-Term Debt and Other Debt Financing*."

These residential loan warehouse facilities could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of our warehouse facilities, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*."

In addition to the five residential loan warehouse facilities described above, in the ordinary course of business we may seek to establish additional warehouse facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a counterparty to one or more of our warehouse facilities becomes insolvent or unable or unwilling to perform its obligations under the facility, we may be unable to access short-term financing we need or fail to recover the full value of our residential mortgage loans financed.

*Securities Repurchase Facilities*. Another source of short-term debt financing is through securities repurchase facilities we have established with various different financial institution counterparties. Under these facilities we do not have an aggregate borrowing limit; however, these facilities are uncommitted, which means that any request we make to borrow funds under these facilities may be declined for any reason. Short-term financing for securities is obtained under these facilities by our transfer of securities to the counterparty in exchange for cash proceeds (in an amount less than 100% of the fair value of the transferred securities), and our covenant to reacquire those securities from the counterparty for the same amount plus a financing charge.

Under these securities repurchase facilities, securities are financed for a fixed period, which would not generally exceed 90 days. We generally intend to repay the short-term financing of a security under one of these facilities through a renewal of that financing with the same counterparty, through a sale of the security, or with other equity or long-term debt capital. While a security is financed under a securities repurchase facility, to the extent the value of the security declines (which value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the security or meet a margin requirement to pledge additional collateral, such as cash or U.S. Treasury securities, in an amount at least equal to the decline in value. See further discussion below under the heading "*–Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*."

At the end of the fixed period applicable to the financing of a security under a securities repurchase facility, if we intend to continue to obtain financing for that security we would typically request the same counterparty to renew the financing for an additional fixed period. If the same counterparty does not renew the financing, it may be difficult for us to obtain financing for that security under one of our other securities repurchase facilities, due to the fact that the financial institution counterparties to our securities repurchase facilities generally only provide financing for securities that we purchased from them or one of their affiliates.

Because our securities repurchase facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*." In addition, with respect to securities that at any given time are already being financed through our securities repurchase facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," below under the heading "*Market Risks*," if and when those securities decline in value, or have been financed for the maximum term permitted under the applicable facility.

Under our securities repurchase facilities, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms (including of the type described above under the heading "*–Residential Loan Warehouse Facilities*") that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under these facilities and these facilities being unavailable to use for future financing needs. In particular, the terms of these facilities include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading "*–Residential Loan Warehouse Facilities*"). Financial covenants included in our repurchase facilities are further described below under the heading "*–Financial Covenants Associated with Short-Term Debt and Other Debt Financing*."

Our securities repurchase facilities could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and
warranties, covenants, events of default, or other terms of our securities repurchase facilities, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*."

In the ordinary course of business we may seek to establish additional securities repurchase facilities that may have similar or more restrictive terms. In the event a counterparty to one or more of our securities repurchase facilities becomes insolvent or unable or unwilling to perform its obligations under the facility, we may be unable to access the short-term financing we need or fail to recover the full value of our securities financed.

*Commercial Mortgage Loan Warehouse Facility*. Another source of short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility that is in place with a financial institution counterparty. Under this warehouse facility, we have an aggregate borrowing limit of $100 million; however, this facility is uncommitted, which means that any request we make to borrow funds under this facility may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under this facility. Short-term financing for commercial mortgage loans is obtained under this facility by our transfer of commercial mortgage loans to a special purpose entity which transfers them to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred commercial mortgage loans), and our covenant to reacquire those commercial mortgage loans from the counterparty for the same amount plus a financing charge. Other periodic payments are also due under the facility.

In order to obtain financing for a commercial mortgage loan under this facility, the commercial mortgage loan must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the commercial mortgage loan is not in a delinquent status. In addition, under this facility, a commercial mortgage loan can only be financed for a maximum period, which period would not generally exceed 180 days. We generally intend to repay the short-term financing of a commercial mortgage loan under this facility at or prior to the expiration of the financing term with the proceeds of a sale or securitization of that commercial mortgage loan, through the proceeds of other short-term borrowings, or with other equity or long-term debt capital. While a commercial mortgage loan is financed under this facility, to the extent the market value of the commercial mortgage loan declines (which market value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the commercial mortgage loan or meet a margin requirement to pledge additional collateral, such as cash or additional commercial mortgage loans, in an amount at least equal to the decline in value. See further discussion below under the heading "*–Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*."

Because this warehouse facility is uncommitted, at any given time we may not be able to obtain additional financing under this facility when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*." In addition, with respect to commercial mortgage loans that at any given time are already being financed through this facility, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*," if and when those commercial mortgage loans become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the facility.

Under our commercial mortgage loan warehouse facility, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. In particular, the terms of this facility include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading "*–Residential Loan Warehouse Facilities*"). Financial covenants included in this warehouse facility are further described below under the heading "*–Financial Covenants Associated with Short-Term Debt and Other Debt Financing*"

Our commercial mortgage loan warehouse facility could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of this facility, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*."

In addition to the commercial mortgage loan warehouse facility described above, in the ordinary course of business we may seek to establish additional facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a

counterparty to one or more of our facilities becomes insolvent or unable or unwilling to perform its obligations under a facility, we may be unable to access the financing we need or we may fail to recover the full value of our commercial mortgage loans financed under the applicable facility.

*Other Short-Term Debt Facilities*. We also maintain a $10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. This bank line of credit is an additional source of short-term financing for us. Similar to the uncommitted warehouse and securities repurchase facilities described herein, under this committed line we make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. The margin call provisions and financial covenants included in this committed line are further described below under the headings "*–Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*" and "*–Financial Covenants Associated with Short-Term Debt and Other Debt Financing*" When we use this committed line to incur short-term debt we are exposed to the market, credit, liquidity, and other types of risks described above with respect to residential loan warehouse and securities repurchase facilities.

*Commercial Debt Investment Repurchase Facility*. Another source of debt financing is secured borrowings through a commercial debt investment repurchase facility that is in place with a financial institution counterparty. Under this repurchase facility, we have an aggregate borrowing limit of $150 million; however, any request we make to borrow funds under this facility secured by a particular commercial debt investment may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under this facility. Financing for commercial debt investments is obtained under this facility by our transfer of commercial debt investments to a special purpose entity which is beneficially owned by the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred commercial debt investments), and our covenant to reacquire those commercial debt investments for the same amount plus a financing charge. Other periodic payments are also due under the facility.

In order to obtain financing for a commercial debt investment under this facility, the commercial debt investment must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the commercial debt investment is not in a delinquent status. This facility has an original three-year term. We generally intend to repay the financing of a commercial debt investment under this facility at or prior to the expiration of the financing term with the proceeds of a securitization or other sale of that commercial debt investment, or with other equity or long-term debt capital. While a commercial debt investment is financed under this facility, to the extent the value of the commercial debt investment declines (which value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the commercial debt investment or meet a margin requirement to pledge additional collateral, such as cash or additional commercial debt investments, in an amount at least equal to the decline in value. See further discussion below under the heading "*–Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*."

Because the counterparty under this facility retains discretion to accept or reject a financing with respect to any particular commercial debt investment, at any given time we may not be able to obtain additional financing under this facility when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*." In addition, with respect to commercial debt investments that at any given time are already being financed through this facility, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*," if and when those commercial debt investments become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the facility.

Under our commercial debt investment repurchase facility, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. In particular, the terms of this facility include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading "*–Residential Loan Warehouse Facilities*"). Financial covenants included in our repurchase facilities are further described below under the heading "*–Financial Covenants Associated with Short-Term Debt and Other Debt Financing*"

Our commercial debt investment repurchase facility could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the

representations and warranties, covenants, events of default, or other terms of this facility, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading "*Risk Factors*," and below under the heading "*Market Risks*."

In addition to the commercial debt investment repurchase facility described above, in the ordinary course of business we may seek to establish additional facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a counterparty to one or more of our facilities becomes insolvent or unable or unwilling to perform its obligations under a facility, we may be unable to access the financing we need or we may fail to recover the full value of our commercial debt investments financed under the applicable facility.

*FHLB Borrowing Facility*. Another source of debt financing is secured borrowings by our wholly-owned subsidiary, RWT Financial, LLC, through a borrowing facility with the Federal Home Loan Bank of Chicago ("FHLBC") that was put into place in July 2014. Under this borrowing facility, we do not have an aggregate borrowing limit; however, any request we make to borrow funds under this facility may be declined for any reason. Borrowings under this facility are secured by our pledge of residential and commercial mortgage loans, other agency and private-label residential mortgage backed securities, cash and cash equivalents, and capital stock of FHLBC held by RWT Financial. Similar to the uncommitted warehouse and securities repurchase facilities described herein, under this facility we make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. The margin call provisions and financial covenants included in this facility are further described below under the headings "*–Margin Call Provisions Associated With Short-Term Debt and Other Debt Financing*" and "*–Financial Covenants Associated With Short-Term Debt and Other Debt Financing* ." When we use this facility to incur debt we are exposed to the market, credit, liquidity, and other types of risks described above with respect to residential loan warehouse and securities repurchase facilities.

*Financial Covenants Associated With Short-Term Debt and Other Debt Financing*

Set forth below is a summary of the financial covenants associated with our short-term debt and other debt financing facilities.

- Residential Loan Warehouse Facilities. As noted above, one source of our short-term debt financing is secured borrowings under residential loan warehouse facilities we have established with five different financial institution counterparties. Financial covenants included in these warehouse facilities are as follows and at June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:
  - Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
  - Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood or maintenance of an amount of cash and cash equivalents in excess of a specified percentage of outstanding short-term recourse indebtedness.
  - Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity and tangible net worth at Redwood.
  - Maintenance of uncommitted residential loan warehouse facilities with a specified level of unused borrowing capacity.
- Securities Repurchase Facilities. As noted above, another source of our short-term debt financing is through secured borrowings under securities repurchase facilities we have established with various financial institution counterparties. Financial covenants included in these securities repurchase facilities are as follows and at June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:
  - Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
  - Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.
  - Maintenance of a minimum ratio of consolidated recourse indebtedness to consolidated adjusted tangible net worth at Redwood.

- Commercial Mortgage Loan Warehouse Facility. As noted above, another source of our short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility that we have in place with a financial institution counterparty. Financial covenants included in this facility are as follows and at June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:
  - Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
  - Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.
  - Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity at Redwood, including a separate minimum ratio for commercial assets which is applicable under certain specified circumstances.
- Committed Line of Credit. As noted above, we also maintain a $10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. The types of financial covenants included in this bank line of credit are a subset of the covenants summarized above.
- Commercial Debt Investment Repurchase Facility. As noted above, one source of our debt financing is secured borrowings under a commercial debt investment repurchase facility we have established with a financial institution counterparty. Financial covenants included in this facility are as follows and at June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:
  - Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
  - Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.
  - Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity at Redwood
- FHLB Borrowing Facility. As noted above, a wholly-owned subsidiary of ours, RWT Financial, also maintains a borrowing facility with the FHLBC, which is secured by, among other things, our pledge of residential and commercial mortgage loans, and agency and private-label residential mortgage backed securities. The types of financial covenants included in this borrowing facility are generally a subset of the covenants summarized above and also include a financial covenant:
  - Maintenance by RWT Financial of a specified amount of unencumbered assets eligible to be pledged to FHLBC.

As noted above, at June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with the financial covenants associated with our short-term debt and other debt financing facilities. In particular, with respect to: (i) financial covenants that require us to maintain a minimum dollar amount of stockholders' equity or tangible net worth, at June 30, 2014 our level of stockholders' equity and tangible net worth resulted in our being in compliance with these covenants by more than $200 million; and (ii) financial covenants that require us to maintain recourse indebtedness below a specified ratio, at June 30, 2014 our level of recourse indebtedness resulted in our being in compliance with these covenants at a level such that we could incur at least $800 million in additional recourse indebtedness.

*Margin Call Provisions Associated With Short-Term Debt and Other Debt Financing*

- Residential Loan Warehouse Facilities. As noted above, one source of our short-term debt financing is secured borrowings under residential loan warehouse facilities we have established with five different financial institution counterparties. These warehouse facilities include the margin call provisions described below and during the three months ended June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from creditors under these warehouse facilities:
  - If at any time the market value (as determined by the creditor) of any residential mortgage loan financed under a facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations (in certain cases), or additional residential mortgage loans) with a value equal to the amount of the decline. If we receive any such demand, (i) under three of our residential loan warehouse facilities, we would generally be required to transfer the additional collateral on the same day (although demands received after a certain time would only require the transfer of additional collateral on the following business day) and (ii) under two of our residential loan warehouse facilities, we would generally be required to transfer the additional collateral on the following business day. The value of additional residential mortgage loans transferred as additional collateral is determined by the creditor.
- Securities Repurchase Facilities. Another source of our short-term debt financing is through secured borrowings under securities repurchase facilities we have established with various financial institution counterparties. These repurchase

facilities include the margin call provisions described below and during the three months ended June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from creditors under these repurchase facilities:

 - If at any time the market value (as determined by the creditor) of any securities financed under a facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations, or additional securities) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the same day. The value of additional securities transferred as additional collateral is determined by the creditor.

- Commercial Mortgage Loan Warehouse Facility. As noted above, another source of our short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility we have in place with a financial institution counterparty. This facility includes the margin call provisions described below and during the three months ended June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from the creditor under this facility:

  - If at any time the market value (as determined by the creditor) of any commercial mortgage loan financed under the facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash or additional commercial mortgage loans) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the following business day. The value of additional commercial mortgage loans transferred as additional collateral is determined by the creditor.

- Committed Line of Credit. As noted above, we also maintain a $10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. Margin call provisions included in this bank line of credit are as follows and during the three months ended June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from this creditor under this line of credit:

  - If at any time the total market value (as determined by two broker-dealers) of the securities that are pledged as collateral under this facility declines to a value less than the outstanding amount of borrowings under this facility, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations, or additional securities) with a value equal to the amount of the difference. If we receive any such demand, we would generally be required to transfer the additional collateral within two business days. The value of additional collateral pledged is determined by the creditor.

- Commercial Debt Investment Repurchase Facility. As noted above, one source of our debt financing is secured borrowings under a commercial debt investment repurchase facility we have established with a financial institution counterparty. This facility includes the margin call provisions described below during the three months ended June 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from the creditor under this facility:

  - If at any time the asset value (as determined by the creditor) of any commercial debt investment financed under the facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash or additional commercial debt investments) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the second business day thereafter (although demands received after a certain time would allow an additional business day for the transfer of additional collateral to occur). The value of additional commercial debt investments transferred as additional collateral is determined by the creditor.

- FHLB Borrowing Facility. As noted above, a wholly-owned subsidiary of ours, RWT Financial, also maintains a borrowing facility with the FHLBC, which is secured by, among other things, our pledge of residential and commercial mortgage loans, and agency and private-label residential mortgage backed securities. The types of financial covenants included in this borrowing facility are generally a subset of the covenants summarized above.

  - If we become aware or have reason to believe that the collateral value of our qualifying collateral has fallen below the required collateral maintenance level (based on information, including but not limited to, updated appraisals, revised model valuations and information obtained in connection with our evaluation of our loan loss reserves), or that a contingency exists which with the lapse of time would result in our failing to meet the collateral maintenance level, or if any collateral ceases to be qualifying collateral, we must deliver additional qualifying collateral sufficient to maintain the required collateral maintenance level.

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## OFF BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

### Off Balance Sheet Arrangements

We do not have any material off balance sheet arrangements.

### Contractual Obligations

The following table presents our contractual obligations and commitments at June 30, 2014, as well as the obligations of the securitization entities that we sponsor and consolidate for financial reporting purposes.

*Table 31 – Contractual Obligations and Commitments*

| June 30, 2014 | Payments Due or Commitment Expiration by Period | | | | |
|---|---|---|---|---|---|
| (In Millions) | Less Than 1 Year | 1 to 3 Years | 3 to 5 Years | After 5 Years | Total |
| **Obligations of Redwood** | | | | | |
| Short-term debt | $ 1,718 | $ - | $ - | $ - | $ 1,718 |
| Convertible notes | - | - | 288 | - | 288 |
| Anticipated interest payments on convertible notes | 13 | 27 | 13 | - | 53 |
| Commercial borrowings | - | 53 | - | - | 53 |
| Anticipated interest payments on commercial borrowings | 3 | - | - | - | 3 |
| Other long-term debt | - | - | - | 140 | 140 |
| Anticipated interest payments on other long-term debt (1) | 9 | 19 | 19 | 166 | 213 |
| Accrued interest payable | 5 | - | - | - | 5 |
| Operating leases | 3 | 6 | 3 | 2 | 14 |
| Total Redwood Obligations and Commitments | $ 1,751 | $ 105 | $ 323 | $ 308 | $ 2,487 |
| **Obligations of Consolidated Entities for Financial Reporting Purposes** | | | | | |
| Consolidated ABS (2) | $ - | $ 19 | $ - | $ 1,780 | $ 1,799 |
| Anticipated interest payments on ABS (3) | 27 | 69 | 92 | 374 | 562 |
| Accrued interest payable | 2 | - | - | - | 2 |
| Total Obligations of Entities Consolidated for Financial Reporting Purposes | 29 | 88 | 92 | 2,154 | 2,363 |
| **Total Consolidated Obligations and Commitments** | $ 1,780 | $ 193 | $ 415 | $ 2,462 | $ 4,850 |

(1) Includes anticipated interest payments related to hedges.
(2) All consolidated ABS issued are collateralized by real estate loans and securities. Although the stated maturity is as shown, the ABS obligations will pay down as the principal balances of these real estate loans or securities pay down. The amount shown is the principal balance of the ABS issued and not necessarily the value reported in our consolidated financial statements.
(3) The anticipated interest payments on consolidated ABS issued is calculated based on the contractual maturity of the ABS and therefore assumes no prepayments of the principal outstanding at June 30, 2014.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

We expect quarter-to-quarter GAAP earnings volatility from our business activities. This volatility can occur for a variety of reasons, including the timing and amount of purchases, sales, calls, and repayment of consolidated assets, changes in the fair values of consolidated assets and liabilities, increases or decreases in earnings from mortgage banking activities, and certain non-recurring events. In addition, the amount or timing of our reported earnings may be impacted by technical accounting issues and estimates, some of which are described below.

***Changes in Premium Amortization for Loans***

The net unamortized premium for loans owned at Redwood, Consolidated Sequoia Entities, and the Commercial Securitization, was $12 million at June 30, 2014. The amount of periodic premium amortization expense we recognize is volatile and dependent on a number of factors, including credit performance of the underlying loans, changes in prepayment speeds, and changes in short-term interest rates. Loan premium amortization was $2 million and $3 million for the six months ended June 30, 2014 and 2013, respectively.

***Changes in Allowance for Loan Losses***

For real estate loans classified as held-for-investment, we establish and maintain an allowance for loan losses based on our estimate of credit losses inherent in our loan portfolios at the reporting date. To calculate the allowance for loan losses, we assess inherent losses by determining loss factors (defaults, loss severities on default liquidations, and the timing of default liquidations) that can be specifically applied to each of the consolidated loans or pools of loans.

Changes in actual defaults or our expectations on loss severities and default timing can have a significant effect on periodic income.

***Changes in the Fair Value of Residential and Commercial Loans Held at Fair Value***

Our residential and commercial loans held-for-sale on our consolidated balance sheet at June 30, 2014, were being held for future securitizations or sales and expected to be sold to non-consolidated securitization entities or third parties. At the time of purchase, we typically elect the fair value option for these loans. For residential and commercial loans for which we have elected the fair value option, changes in fair values are recorded in mortgage banking activities, net, through the consolidated statements of income in the period in which the valuation change occurs. Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant period-to-period GAAP earnings volatility.

The fair value of loans is affected by, among other things, changes in interest rates, credit performance, prepayments, and market liquidity. To the extent interest rates change or market liquidity and or credit conditions materially change, the value of these loans could decline below their cost basis, which could have a material effect on reported earnings.

***Changes in Mortgage Banking Income***

The amount of income that can be earned from mortgage banking activities is primarily dependent on the volume of loans we are able to acquire or originate and any potential profit we earn upon the sale or securitization of these loans. Our ability to acquire or originate residential and commercial loans and the volume of loans we acquire or originate is dependent on many factors that are beyond our control, including general economic conditions and changes in interest rates, loan origination volumes industry-wide and at the sellers we purchase our loans from, increased regulation, and competition from other financial institutions. Our profitability from mortgage banking activities is also dependent on many factors, including our ability to effectively hedge certain risks related to changes in interest rates and other factors that are beyond our control, including changes in market credit risk pricing. Additionally, our income from mortgage banking activities is generally generated over the period from when we originate or identify a loan for purchase until we subsequently sell or securitize the loan. This income may encompass positive or negative market valuation adjustments on loans, hedging gains or losses associated with related risk management activities, and any other related transaction expenses, and may be realized unevenly over the course of one or more quarters for financial reporting purposes. Examples of additional factors that could impact our profitability include those discussed in Part I, Item 1A – Risk Factors of our Annual Report on Form 10-K for the fiscal year ending December 31, 2013, and under the headings "*Changes in the Fair Value of Residential and Commercial Loans Held at Fair Value*" and "*Changes in Fair Values of Derivative Financial Instruments*." Changes in the volumes of loans acquired or originated in connection with our mortgage banking activities and our profitability on these activities can have a significant effect on periodic income.

***Changes in Yields for Securities***

The yields we project on real estate securities can have a significant effect on the periodic interest income we recognize for financial reporting purposes. Yields can vary as a function of credit results, prepayment rates, and interest rates. If estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected for assets acquired at a discount to principal balance), the yield over the remaining life of the security may be adjusted upwards. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected for assets acquired at a discount to principal balance), the yield over the remaining life of the security may be adjusted downward.

Changes in the actual maturities of real estate securities may also affect their yields to maturity. Actual maturities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of AFS securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than ten years. There is no assurance that our assumptions used to estimate future cash flows or the current period's yield for each asset will not change in the near term, and any change could be material.

***Changes in Fair Values of Securities***

All securities owned at Redwood and Legacy Consolidated Entities are classified as either trading or AFS securities, and in both cases are carried on our consolidated balance sheets at their estimated fair values. For trading securities, changes in fair values are recorded in the consolidated statements of income. Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant GAAP earnings volatility each quarter.

For AFS securities, cumulative unrealized gains and losses are recorded as a component of accumulated other comprehensive income in our consolidated balance sheets. Unrealized gains are not credited to current earnings and unrealized losses are not charged against current earnings to the extent they are temporary in nature. Certain factors may require us, however, to recognize declines in the values of AFS securities as other-than-temporary impairments and record them through our current earnings. Factors that determine other-than-temporary-impairment include a change in our ability or intent to hold AFS securities, adverse changes to projected cash flows of assets, or the likelihood that declines in the fair values of assets would not return to their previous levels within a reasonable time. Impairments on AFS securities can lead to significant GAAP earnings volatility each quarter. In addition, sales of securities in large unrealized gain or loss positions that are not impaired can lead to significant GAAP earnings volatility each year.

***Changes in Fair Values of Mortgage Servicing Rights***

Mortgage servicing rights are carried on our consolidated balance sheets at their estimated fair values, with changes in fair values recorded in the consolidated statements of income as a component of MSR income (loss), net. Periodic fluctuations in the values of these investments are inherently volatile and can lead to significant GAAP earnings volatility each quarter. Periodic fluctuations in the values of our mortgage servicing rights can be caused by actual prepayments on the underlying loans, changes in assumptions regarding future projected prepayments on the underlying loans, or changes in the discount rate assumptions used to value mortgage servicing rights.

***Changes in Fair Values of Derivative Financial Instruments***

We can experience significant earnings volatility from our use of derivatives. We generally use derivatives as part of our mortgage banking activities (e.g., to manage risks associated with loans we plan to acquire and subsequently sell or securitize), and to manage variability in debt interest expense indexed to adjustable rates, and cash flows on assets and liabilities that have different coupon rates (fixed rates versus floating rates, or floating rates based on different indices). The nature of the instruments we use and the accounting treatment for the specific assets, liabilities, and derivatives may therefore lead to volatility in our periodic earnings, even when we are meeting our hedging objectives.

Some of our derivatives are accounted for as trading instruments with all associated changes in value recorded through our consolidated statements of income. Changes in value of the assets and liabilities we manage by using derivatives may not be accounted for similarly. This could lead to reported income and book values in specific periods that do not necessarily reflect the economics of our risk management strategy. Even when the assets and liabilities are similarly accounted for as trading instruments, periodic changes in their values may not coincide as other market factors (e.g., supply and demand) may affect certain instruments and not others at any given time.

***Changes in Loss Contingency Reserves***

We may be exposed to various loss contingencies, including, without limitation, those described in *Note 14* to the financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q. In accordance with FASB guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish them when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. The establishment of a loss contingency reserve, the subsequent increase in a reserve or release of reserves previously established, or the recognition of a loss in excess of previously established reserves, can occur as a result of various factors and events that affect management's opinion of whether the standard for establishing, increasing, or continuing to maintain, a reserve has been met. Changes in the loss contingency reserves can lead to significant GAAP earnings volatility each quarter.

***Changes in Provision for Taxes***

Our quarterly tax provision is determined by multiplying actual year-to-date GAAP earnings by our estimated annual effective tax rate ("ETR") and subtracting any tax expense recorded in prior quarters of the current year. The ETR is calculated by dividing the estimated annual tax expense by the estimated annual GAAP pre-tax earnings for the current year. Our estimated annual tax expense includes estimates for GAAP earnings, permanent and temporary book-to-tax differences, valuation allowances, and taxable income. Changes in our estimates and fluctuations in quarterly GAAP earnings can cause volatility in the quarterly tax provision. It is possible that a change in estimates could cause us to have a tax provision in one quarter and a tax benefit in a later quarter. Changes in the tax provision can lead to significant GAAP earnings volatility each quarter.

**Market Risks**

We seek to manage risks inherent in our business — including but not limited to credit risk, interest rate risk, prepayment risk, liquidity risk, and fair value risk — in a prudent manner designed to enhance our earnings and dividends and preserve our capital. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, and to maintain capital levels consistent with these risks. Information concerning the risks we are managing, how these risks are changing over time, and potential GAAP earnings and taxable income volatility we may experience as a result of these risks is discussed in Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

**Other Risks**

In addition to the market and other risks described above, our business and results of operations are subject to a variety of types of risks and uncertainties, including, among other things, those described under the caption "*Risk Factors*" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

**NEW ACCOUNTING STANDARDS**

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

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

Information concerning market risk is incorporated herein by reference to Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013, as supplemented by the information under "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" and "*Market Risks*" within Item 2 above. Other than the developments described thereunder, including changes in the fair values of our assets, there have been no other material changes in our quantitative or qualitative exposure to market risk since December 31, 2013.

## Item 4. Controls and Procedures

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

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

There have been no changes in our internal control over financial reporting during the second quarter of 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the "FHLB-Seattle") filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. ("SRF"), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the "FHLB-Seattle Defendants") alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the "Seattle Certificate") issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the "2005-4 RMBS") and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys' fees and costs. The Seattle Certificate was issued with an original principal amount of approximately $133 million, and, as of June 30, 2014, the FHLB-Seattle has received approximately $115.3 million of principal and $11.0 million of interest payments in respect of the Seattle Certificate. As of June 30, 2014, the Seattle Certificate had a remaining outstanding principal amount of approximately $18.0 million. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle's claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation ("Schwab") filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the "Schwab Defendants") alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the "Schwab Certificate") issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. Schwab alleges a claim for negligent misrepresentation under California state law and seeks unspecified damages and attorneys' fees and costs. The Schwab Certificate was issued with an original principal amount of approximately $14.8 million, and, as of June 30, 2014, Schwab has received approximately $12.8 million of principal and $1.3 million of interest payments in respect of the Schwab Certificate. As of June 30, 2014, the Schwab Certificate had a remaining outstanding principal amount of approximately $2.0 million. SRF has denied Schwab's allegations. This case is in discovery, and no trial date has been set. We intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named as defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about October 15, 2010, the Federal Home Loan Bank of Chicago ("FHLB-Chicago") filed a complaint in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the "FHLB-Chicago Defendants") alleging that the FHLB-Chicago Defendants made false or misleading statements in offering materials for various RMBS sold or issued by the FHLB-Chicago Defendants or entities controlled by them. FHLB-Chicago subsequently amended the complaint to name Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc., as defendants. With respect to Redwood Trust, Inc., RWT Holdings, Inc., and SRF, the FHLB-Chicago alleges that SRF, Redwood Trust, Inc., and RWT Holdings, Inc. made false or misleading statements in the offering materials for two mortgage pass-through certificates (the "Chicago Certificates") issued in the Sequoia Mortgage Trust 2006-1 securitization transaction (the "2006-1 RMBS") and purchased by the FHLB-Chicago. The complaint alleges that the alleged misstatements concern, among other things, the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2006-1 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, (4) ratings assigned to the Chicago Certificates, and (5) due diligence performed on these mortgage loans. The FHLB-Chicago alleges claims under Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law (N.C.G.S.A. §78A-8(2) & §78A-56(a)) as well as a claim for negligent misrepresentation under Illinois common law. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of the Chicago Certificates and to

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collect interest on the original purchase prices at the statutory interest rate of 10% per annum from the dates of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys' fees and costs. The first of the Chicago Certificates was issued with an original principal amount of approximately $105 million and, as of June 30, 2014, the FHLB Chicago has received approximately $73.6 million of principal and $24.6 million of interest payments in respect of this Chicago Certificate. As of June 30, 2014, this Chicago Certificate had a remaining outstanding principal amount of approximately $29.8 million (after taking into account approximately $1.8 million of principal losses allocated to this Chicago Certificate). The second of the Chicago Certificates was issued with an original principal amount of approximately $379 million and, as of June 30, 2014, the FHLB Chicago has received approximately $263.7 million of principal and $83.0 million of interest payments in respect of this Chicago Certificate. As of June 30, 2014, this Chicago Certificate had a remaining outstanding principal amount of approximately $108.2 million (after taking into account approximately $6.8 million of principal losses allocated to this Chicago Certificate). SRF, Redwood Trust, Inc., and RWT Holdings, Inc. have denied FHLB-Chicago's allegations. This case is in discovery, and no trial date has been set. Redwood agreed to indemnify the underwriters of the 2006-1 RMBS, which underwriters were also named as defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

In May 2010, we received an Order from the SEC, pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. The SEC's Order required us to provide information regarding, among other things, our trading practices and valuation policies relating to our business of sponsoring and managing collateralized debt obligation issuers. We have responded to the Order. The Order from the SEC indicates that it should not be construed as an indication by the SEC or its staff that any violations of law have occurred. The SEC could, however, as a result of our response to this Order or otherwise, allege that we violated applicable law or regulation in the conduct of our collateralized debt obligation business.

In November 2009, we received a subpoena from the National Credit Union Administration ("NCUA"), which is the federal agency that charters and supervises federal credit unions, as part of its investigation of the circumstances relating to the U.S. Central Federal Credit Union being placed into conservatorship in March 2009, including the U.S. Central Federal Credit Union's investment in various RMBS. The NCUA requested information relating to, among other things, two RMBS (i) issued by a securitization trust with respect to which SRF was the depositor and (ii) purchased at the time of issuance by the U.S. Central Federal Credit Union. We have responded to the subpoena. The subpoena from the NCUA states that it should not be construed as an indication by the NCUA or its staff that any violation of law has occurred. The NCUA could, however, as a result of our response to this subpoena or otherwise, allege that we did violate applicable law or regulation in the conduct of our securitization business.

Other than as disclosed in the preceding paragraphs of this Item 1, there are no material pending legal proceedings, or material changes with respect to pending legal proceedings, in each case, to which we or any of our subsidiaries is a party or of which our property is the subject.

**Item 1A. Risk Factors**

Our risk factors are discussed under Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013.

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

During the six months ended June 30, 2014, we did not sell any equity securities that were not registered under the Securities Act of 1933, as amended. We announced a stock repurchase plan on November 5, 2007, for the repurchase of up to a total of 5,000,000 shares. This plan replaced all previous share repurchase plans and has no expiration date. We did not repurchase any shares under this plan during the six months ended June 30, 2014. At June 30, 2014, 4,005,985 shares remained available for repurchase under our stock repurchase plan.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Not Applicable**

**Item 5. Other Information**

None.

**Item 6. Exhibits**

| Exhibit Number | Exhibit |
|---|---|
| 3.1 | Articles of Amendment and Restatement of the Registrant, effective July 6, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1, filed on August 6, 2008) |
| 3.1.1 | Articles Supplementary of the Registrant, effective August 10, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.1, filed on August 6, 2008) |
| 3.1.2 | Articles Supplementary of the Registrant, effective August 11, 1995 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.2, filed on August 6, 2008) |
| 3.1.3 | Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008) |
| 3.1.4 | Certificate of Amendment of the Registrant, effective June 30, 1998 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.4, filed on August 6, 2008) |
| 3.1.5 | Articles Supplementary of the Registrant, effective April 7, 2003 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.5, filed on August 6, 2008) |
| 3.1.6 | Articles of Amendment of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008) |
| 3.1.7 | Articles of Amendment of the Registrant, effective May 19, 2009 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009) |
| 3.1.8 | Articles of Amendment of the Registrant, effective May 24, 2011 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 20, 2011) |
| 3.1.9 | Articles of Amendment of the Registrant, effective May 18, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2012) |
| 3.1.10 | Articles of Amendment of the Registrant, effective May 16, 2013 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2013) |
| 3.2.1 | Amended and Restated Bylaws of the Registrant, as adopted on March 5, 2008 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008) |
| 3.2.2 | First Amendment to Amended and Restated Bylaws of the Registrant, as adopted on May 17, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.2, filed on May 21, 2012) |
| 10.1* | Redwood Trust, Inc. 2014 Incentive Award Plan (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 10.1, filed on May 23, 2014) |
| 10.2* | Form of Redwood Trust, Inc. Deferred Stock Unit Award Agreement (2014) |
| 10.3* | Form of Redwood Trust, Inc. Performance Stock Unit Award Agreement (2014) |
| 10.4* | Form of Redwood Trust, Inc. Restricted Stock Award Agreement (2014) |
| 10.5* | Fifth Amendment to Amended and Restated Employment Agreement, by and between Martin S. Hughes and the Registrant, dated as of August 6, 2014 |
| 10.6* | Fifth Amendment to Amended and Restated Employment Agreement, by and between Brett D. Nicholas and the Registrant, dated as of August 6, 2014 |
| 10.7 | Second Amendment to Lease, effective as of June 23, 2014, between MG-Point, LLC, as Landlord, and the Registrant, as Tenant |
| 10.8 | Advances, Collateral Pledge, and Security Agreement between the Federal Home Loan Bank of Chicago and RWT Financial, LLC, dated as of July 16, 2014 |
| 10.9 | Financial Covenant Supplement to Advances, Collateral Pledge, and Security Agreement between the Federal Home Loan Bank of Chicago and RWT Financial, LLC, dated as of July 16, 2014 |
| 10.10 | Guaranty, dated July 16, 2014, given by Redwood Trust, Inc. in favor of the Federal Home Loan Bank of Chicago |
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2014, is filed in XBRL-formatted interactive data files:<br>(i) Consolidated Balance Sheets at June 30, 2014 and December 31, 2013;<br>(ii) Consolidated Statements of Income for the three and six months ended June 30, 2014 and 2013;<br>(iii) Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2014 and 2013; |

| Exhibit Number | Exhibit |
|---|---|
| | (iv) Consolidated Statements of Changes in Equity for the six months ended June 30, 2014 and 2013;<br>(v) Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013; and<br>(vi) Notes to Consolidated Financial Statements. |

* Indicates exhibits that include management contracts or compensatory plans or arrangements.

## SIGNATURES

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

**REDWOOD TRUST, INC.**

| | |
|---|---|
| Date: August 8, 2014 | By: /S/ MARTIN S. HUGHES<br>Martin S. Hughes<br>Chief Executive Officer<br>(Principal Executive Officer) |
| Date: August 8, 2014 | By: /S/ CHRISTOPHER J. ABATE<br>Christopher J. Abate<br>Chief Financial Officer<br>(Principal Financial Officer) |
| Date: August 8, 2014 | By: /S/ COLLIN L. COCHRANE<br>Collin L. Cochrane<br>Controller<br>(Principal Accounting Officer) |

## EXHIBIT INDEX

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**Exhibit 10.2**

**REDWOOD TRUST, INC.**
**DEFERRED STOCK UNIT AWARD AGREEMENT**

**DEFERRED STOCK UNIT AWARD AGREEMENT** dated as of the ___ day of _____ 20 __ (the “Award Agreement”), by and between Redwood Trust, Inc., a Maryland corporation (the “Company”), and _____, an [employee/director] of the Company (the “Participant”).

Pursuant to the Redwood Trust, Inc. 2014 Incentive Award Plan (as may be amended from time to time, the “Plan”), the Compensation Committee (the “Committee”) has determined that the Participant is to be granted an award of Deferred Stock Units for shares of the Company’s common stock, par value $0.01 per share (“Common Stock”), on the terms and conditions set forth herein (the “Award”), and the Company hereby grants such Award. This Award is being made in connection with a deferral of compensation by the Participant pursuant to the Redwood Trust, Inc. Executive Deferred Compensation Plan, as amended to date (the “Deferred Compensation Plan”), and the executed Deferral Election attached hereto as Exhibit A (the “Deferral Election”). Any capitalized terms not defined herein shall have the meaning set forth in the Plan or the Deferred Compensation Plan, as applicable.

**1. Number of Shares Awarded; Deferral Election.** This Award entitles the Participant to receive ___ Shares of the Company’s Common Stock (the “Award Shares”), upon expiration of the Restricted Period described below.

**2. Dividends.** In accordance with Section 10.4 of the Plan, the number of Award Shares set forth in Section 1 shall not be adjusted to reflect the payment of regular cash dividends declared on the Company’s common stock during the Restricted Period. The Participant will instead be entitled to dividend equivalent payments (“DERs”) with respect to the Award Shares pursuant to the Plan or the Deferred Compensation Plan and in accordance with the applicable Deferral Election.

**3. Vesting and Restricted Periods.**

(a) The Award Shares shall vest on the following schedule:

As of______ __, 20__, 25%

At the beginning of each subsequent calendar quarter (beginning_____ __, 20__), 6.25%;

All Award Shares shall be fully vested as of______ __, 20__.

Award Shares that have become vested pursuant to this Section 3(a) are referred to as “Vested Award Shares”. The period from the date of this Award to the applicable date or dates specified for delivery of such shares is referred to as the “Restricted Period”.

(b) No Award Shares shall be credited to the Participant’s Deferral Account until they have become Vested Award Shares. Vested Award Shares shall be delivered to the Participant at the time or times provided in the Deferral Election and the Deferred Compensation Plan (or any re-deferral election made in accordance with Section 409A of the Code and the terms of the Deferred Compensation Plan). Vested Award Shares shall not be forfeited in the event of the Participant’s Termination of Service as an Employee but rather delivery of such Shares shall continue to be governed by the terms of the Deferral Election and the Deferred Compensation Plan (or any re-deferral election made in accordance with Section 409A of the Code and the terms of the Deferred Compensation Plan). In connection with the delivery of Vested Award Shares to the Participant, Participant and the Company agree that delivery of such Vested Award Shares shall be net of a number of such Shares that are withheld by the Company in order to satisfy the applicable tax withholding obligation relating to such delivery of Vested Award Shares to the Participant.

(c) Upon the Participant’s Termination of Service as an Employee for any reason other than death or Disability prior to expiration of the Restricted Period, any Award Shares not vested at the time of such termination shall become ineligible for crediting to Participant’s Deferral Account and shall be forfeited. Upon

the Participant's Termination of Service as an Employee due to death or Disability prior to the expiration of the Restricted Period, any Award Shares not vested at the time of such termination shall immediately vest and be credited to the Participant's Deferral Account and shall not be forfeited. Notwithstanding anything herein or in the Plan or the Deferred Compensation Plan to the contrary, for purposes of this Section 3(c), a "Disability" shall only exist if the Participant is "disabled" within the meaning of Section 409A.

**4.** **At-Will Employment.** This Award Agreement is not an employment contract and nothing in this Award Agreement shall be deemed to create in any way whatsoever any obligation of the Participant to continue as an Employee of the Company or on the part of the Company to continue the employment of the Participant with the Company. It is understood and agreed to by the Participant that the Award and participation in the Plan or the Deferred Compensation Plan does not alter the at-will nature of the Participant's relationship with the Company (subject to the terms of any separate employment agreement Participant may have with the Company). The at-will nature of Participant's relationship with the Company can only be altered by a writing signed by both the Participant and the President of the Company.

**5.** **Notices.** Any notice required or permitted under this Award Agreement shall be deemed given when delivered personally, or when deposited in a United States Post Office, postage prepaid, addressed, as appropriate, to the Participant either at the Participant's address set forth below or such other address as the Participant may designate in writing to the Company, and to the Company: Attention: General Counsel, at the Company's address or such other address as the Company may designate in writing to the Participant.

**6.** **Failure to Enforce Not a Waiver.** The failure of the Company to enforce at any time any provision of this Award Agreement shall in no way be construed to be a waiver of such provision or of any other provision hereof.

**7.** **Existing Agreements.** This Award Agreement does not supersede nor does it modify any existing agreements between the Participant and the Company.

**8.** **Incorporation of Plan.** The Plan and the Deferred Compensation Plan are incorporated by reference and made a part of this Award Agreement, and this Award Agreement is subject to all terms and conditions of the Plan and the Deferred Compensation Plan as in effect from time to time. Notwithstanding the foregoing, this Award Agreement is intended to comply with Section 409A of the Code and this Award Agreement, the Plan and Deferred Compensation Plan shall be interpreted in a manner consistent with such intent, and any provisions of this Award Agreement, the Plan or the Deferred Compensation Plan that would cause the Award to fail to satisfy the requirements for an effective deferral of compensation under Section 409A of the Code shall have no force and effect.

**9.** **Amendments.** This Award Agreement may be amended or modified at any time by an instrument in writing signed by the parties hereto. Notwithstanding the foregoing, the Deferral Election shall be irrevocable and the dates specified for distribution of Vested Award Shares may not be modified after the date hereof except as otherwise permitted under Section 409A of the Code.

[*Signature page follows*.]

**IN WITNESS WHEREOF**, the parties have executed this Award Agreement on the day and year first above written.

**REDWOOD TRUST, INC.**

By: ______________________________

Andrew P. Stone
General Counsel & Secretary
One Belvedere Place, Suite 300
Mill Valley, CA 94941

The undersigned hereby accepts and agrees to all the terms and provisions of this Award Agreement and to all the terms and provisions of the Plan herein incorporated by reference.

______________________________

[Insert Participant Name]
c/o Redwood Trust, Inc.
One Belvedere Place, Suite 300
Mill Valley, CA 94941

**Exhibit 10.3**

**REDWOOD TRUST, INC.**
**PERFORMANCE STOCK UNIT AWARD AGREEMENT**

**PERFORMANCE STOCK UNIT AWARD AGREEMENT** dated as of the __ day of ____, 20__ (the "Award Agreement"), by and between Redwood Trust, Inc., a Maryland corporation (the "Company"), and ______, an employee of the Company (the "Participant").

Pursuant to the Redwood Trust, Inc. 2014 Incentive Award Plan (as may be amended from time to time, the "Plan"), the Compensation Committee (the "Committee") has determined that the Participant is to be granted a Performance Stock Unit award for shares of the Company's common stock, par value $0.01 per share ("Common Stock") on the terms and conditions set forth herein (the "Award"), and the Company hereby grants such Award. This Award is being made in connection with a deferral of compensation by the Participant pursuant to the Redwood Trust, Inc. Executive Deferred Compensation Plan (the "Deferred Compensation Plan") and the executed Deferral Election attached hereto as Exhibit B (the "Deferral Election"). Any capitalized terms not defined herein shall have the meaning set forth in the Plan or the Deferred Compensation Plan, as applicable.

**1.** **Number of Performance Stock Units Awarded.** This Award Agreement sets forth the terms and conditions of a Performance Stock Unit Award with a target award of ______ shares of Common Stock, as adjusted to reflect cash dividends declared on the Common Stock pursuant to Section 2 (the "Target Shares"). The number of units representing shares of Common Stock that shall be credited to the Participant's Deferral Account pursuant to this Award (the "Award Shares") shall be determined based upon the Company's achievement of the Performance Goals set forth in Exhibit A hereto and may range from [zero] percent ([0]%) to [two hundred] percent ([200]%) of the Target Shares.

**2.** **Effect of Dividends on Target Shares.** On the last day of the Performance Period, the number of Target Shares set forth in Section 1 shall automatically be increased to reflect all cash dividends, if any, which have been paid to all or substantially all holders of the outstanding shares of Common Stock during the Performance Period (as such term is defined in Exhibit A). On such date, the Target Shares shall be automatically increased by an aggregate number of shares determined by multiplying (x) the target award amount set forth in Section 1 above by (y) the Dividend Reinvestment Factor (as such term is defined below).

"Dividend Reinvestment Factor" shall mean the number of shares of Common Stock that would have been acquired from the reinvestment of cash dividends, if any, which have been paid to all or substantially all holders of the outstanding shares of Common Stock during the Performance Period, with respect to one share of Common Stock outstanding on the first day of the Performance Period. Such number of shares shall be determined cumulatively, for each cash dividend paid during the Performance Period (beginning with the first cash dividend paid during the Performance Period and continuing chronologically with each subsequent cash dividend paid during the Performance Period (and in each case other than the first such cash dividend, taking into account any increase in shares resulting from the application of this formula to the chronologically immediately preceding cash dividend)), by multiplying (i) the applicable number of shares of Common Stock immediately prior to the record date of such cash dividend (which in the case of the first cash dividend paid during the Performance Period shall be one) by (ii) the per share amount of such cash dividend and dividing the product by the Fair Market Value per share of Common Stock on the payment date of such dividend.

**3.** **Vesting and Payment of Award.** The Award Shares shall vest and be credited effective as of the last day of the Performance Period, if at all, when the Committee determines, in its sole discretion, whether and to what extent the Performance Goals set forth in Exhibit A have been attained. The crediting of the Award Shares is contingent on the attainment of the Performance Goals as set forth on Exhibit A. Upon such determination by the Committee and subject to the provisions of the Plan and this Award Agreement, the Participant shall be entitled to crediting of that portion of the Performance Stock Units as corresponds to the Performance Goals attained (as determined by the Committee in its sole discretion) as set forth on Exhibit A.

No Award Shares shall be credited to the Participant's Deferral Account unless the Committee determines, in its sole discretion, whether and to what extent the Performance Goals set forth in Exhibit A have been attained and the number of Award Shares earned pursuant to the Award have been determined. Any shares of

Common Stock in respect of Award Shares credited to the Participant's Deferral Account shall be delivered to the Participant at the time or times provided in the Deferral Election and the Deferred Compensation Plan (or any re-deferral election made in accordance with Section 409A and the terms of the Deferred Compensation Plan). [In connection with the delivery of Award Shares to the Participant, the Participant and the Company agree that delivery of such Award Shares shall be net of a number of such shares which shall be forfeited by the Participant in order to satisfy the applicable tax withholding obligation relating to such delivery to the Participant.]

**4. Forfeiture of Performance Stock Units.**

(a) Upon (i) the Participant's Retirement (as defined below) or (ii) the Participant's Termination of Service as an Employee by the Company without Cause (as defined below), in either case, prior to expiration of the Performance Period, the Target Shares shall be reduced on a pro-rata basis to reflect the number of days of employment completed during the Performance Period, and the Award shall continue to be eligible to vest and become payable based on such prorated number of Target Shares and the Performance Goals.

(b) Upon the Participant's Termination of Service as an Employee due to death or Disability prior to expiration of the Performance Period, the Target Shares shall not be reduced and the Award shall continue to be eligible to vest and become payable based on the number of Target Shares and the Performance Goals.

(c) Upon the Participant's Termination of Service as an Employee for any reason other than death, Disability, Retirement or without Cause, prior to expiration of the Performance Period, any Award Shares not vested at the time of such termination shall become ineligible for crediting to the Participant's Deferral Account and shall be forfeited.

(d) Any Award Shares which have been credited to the Participant's Deferral Account prior to the Participant's Termination of Service as an Employee shall not be forfeited in the event of such Termination of Service as an Employee but rather delivery of such shares shall continue to be governed by the terms of the Deferral Election and the Deferred Compensation Plan (or any re-deferral election made in accordance with Section 409A and the terms of the Deferred Compensation Plan).

For purposes of this Award Agreement, "Cause" shall mean (i) the Participant's material failure to substantially perform the reasonable and lawful duties of his or her position for the Company, which failure shall continue for thirty (30) days after notice thereof by the Company to the Participant; (ii) acts or omissions constituting gross negligence, recklessness or willful misconduct on the part of the Participant in respect of the performance of his or her duties hereunder, his or her fiduciary obligations or otherwise relating to the business of the Company; (iii) the habitual or repeated neglect of his or her duties by the Participant; (iv) the Participant's conviction of a felony; (v) theft or embezzlement, or attempted theft or embezzlement, of money or tangible or intangible assets or property of the Company or its employees, customers, clients, or others having business relations with the Company; (vi) any act of moral turpitude by the Participant injurious to the interest, property, operations, business or reputation of the Company; or (vii) unauthorized use or disclosure of trade secrets or confidential or proprietary information pertaining to Company business.

For purposes of this Award Agreement, "Retirement" shall mean a Termination of Service as an Employee due to retirement (as determined by the Committee in its sole discretion) if such Termination of Service as an Employee occurs on or after both (i) the Participant's 55th birthday and (ii) the completion by the Participant of 10 years of employment with the Company (which employment need not be continuous).[1]

**5. Adjustments.** This Award and the Performance Goals shall be subject to adjustment as set forth in this Award Agreement and the Plan.

**6. At-Will Employment.** This Award Agreement is not an employment contract and nothing in this Award Agreement shall be deemed to create in any way whatsoever any obligation of the Participant to continue

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1 Matt – We have delete the adjustment provision as this is now covered in the plan.

in the employ or service of the Company or on the part of the Company to continue the employment or other service relationship of the Participant with the Company. It is understood and agreed to by the Participant that the Award and participation in the Plan or the Deferred Compensation Plan does not alter the at-will nature of the Participant's relationship with the Company (subject to the terms of any separate employment agreement the Participant may have with the Company). The at-will nature of the Participant's relationship with the Company can only be altered by a writing signed by both the Participant and the President of the Company.

**7.** **Notices.** Any notice required or permitted under this Award Agreement shall be deemed given when delivered personally, or when deposited in a United States Post Office, postage prepaid, addressed, as appropriate, to the Participant either at the Participant's address set forth below or such other address as the Participant may designate in writing to the Company, and to the Company: Attention: General Counsel, at the Company's address or such other address as the Company may designate in writing to the Participant.

**8.** **Failure to Enforce Not a Waiver.** The failure of the Company to enforce at any time any provision of this Award Agreement shall in no way be construed to be a waiver of such provision or of any other provision hereof.

**9.** **Existing Agreements.** This Award Agreement does not supersede nor does it modify any existing agreements between the Participant and the Company.

**9.** **Incorporation of Plan.** The Plan and the Deferred Compensation Plan are incorporated by reference and made a part of this Award Agreement, and this Award Agreement is subject to all terms and conditions of the Plan and the Deferred Compensation Plan as in effect from time to time. Notwithstanding the foregoing, this Award Agreement is intended to comply with Section 409A of the Code and this Award Agreement, the Plan and Deferred Compensation Plan shall be interpreted in a manner consistent with such intent, and any provisions of this Agreement, the Plan or the Deferred Compensation Plan that would cause the Award to fail to satisfy the requirements for an effective deferral of compensation under Section 409A of the Code shall have no force and effect.

**10.** **Amendments.** This Award Agreement may be amended or modified at any time by an instrument in writing signed by the parties hereto. Notwithstanding the foregoing, the Deferral Election shall be irrevocable and the dates specified for distribution of vested Award Shares may not be modified after the date hereof except as otherwise permitted under Section 409A of the Code.

[*Signature page follows*.]

**IN WITNESS WHEREOF**, the parties have executed this Award Agreement on the day and year first above written.

**REDWOOD TRUST, INC.**

By: ______________________________

Andrew P. Stone
General Counsel & Corporate Secretary
One Belvedere Place, Suite 300
Mill Valley, CA 94941

The undersigned hereby accepts and agrees to all the terms and provisions of this Award Agreement and to all the terms and provisions of the Plan herein incorporated by reference.

______________________________

[Insert Participant Name]
c/o Redwood Trust, Inc.
One Belvedere Place, Suite 300
Mill Valley, CA 94941

## EXHIBIT A
## PERFORMANCE GOALS

**Performance Period:** The performance period begins [*insert grant date*] and ends on [*insert 3rd anniversary of grant date*] (the "Performance Period").

**Performance Goals:** The number of Award Shares which will vest and be credited to the Participant's Deferral Account at the end of the Performance Period shall be determined based upon the Company's cumulative total shareholder return ("TSR") for the performance period in accordance with the following schedule:

| TSR | % of Target Shares Credited to Deferral Account |
|---|---|
| Less than [0]% | [0]% |
| [25]% | [100]% |
| [125]% or greater | [200]% |

If the actual performance results fall between [0]% and [25]% TSR, or between [25]% and [125]% TSR, the actual number of Award Shares which shall vest and be credited to the Participant's Deferral Account determined based on a straight-line, mathematical interpolation between the applicable vesting percentages. In no event shall the number of Award Shares exceed [200]% of the Target Shares. In the event the TSR is equal to or less than [0]% at the end of the Performance Period, all Award Shares shall become ineligible for crediting to the Participant's Deferral Account and shall be forfeited.

**Cumulative Total Shareholder Return:** TSR shall mean, with respect to a share of Common Stock outstanding on the first day of the Performance Period, the percentage by which:

(A) the sum of:

(x) the Per Share Price as of the Valuation Date, plus

(y) the Per Share Price as of the Valuation Date multiplied by the Dividend Reinvestment Factor,

exceeds,

(B) $_____[1].

Notwithstanding the foregoing, the Committee shall make appropriate adjustments in calculating TSR to reflect any dividends which may be declared during the forty (40) consecutive trading days prior to the end of the Performance Period, as determined by the Committee in its sole discretion.

1 The average of the closing prices of the Company's Common Stock during the forty (40) consecutive trading days ending on the day prior to the first day of the Performance Period.

"Per Share Price" shall mean the average of the closing prices of the Company's Common Stock during the forty (40) consecutive trading days ending on the day prior to the applicable Valuation Date; *provided, however*, that for purposes of calculating the Per Share Price in the event of a Change in Control the Per Share Price shall be the price per share of Common Stock paid in connection with such Change in Control.

"Valuation Date" means with respect to the Performance Period, [*insert last day of Performance Period*]; *provided, however*, that in the event of a Change in Control that occurs prior to [*insert last day of Performance Period*], the Valuation Date shall mean the date of the Change in Control.

**Exhibit 10.4**

**REDWOOD TRUST, INC.**
**RESTRICTED STOCK AWARD AGREEMENT**

**RESTRICTED STOCK AWARD AGREEMENT** dated as of the __ day of _____, 20__ (this “Agreement”), by and between Redwood Trust, Inc., a Maryland corporation (the “Corporation”), and _____, an employee of the Corporation (the “Purchaser”).

Pursuant to the Redwood Trust, Inc. 2014 Incentive Award Plan (as may be amended from time to time, the “Plan”), the Corporation has authorized the grant to the Purchaser of an award of Restricted Stock on the terms and conditions set forth herein, and the Corporation hereby grants such award. Any capitalized terms not defined herein shall have the meaning set forth in the Plan.

In consideration of the mutual covenants and representations set forth herein, the Corporation and the Purchaser agree as follows:

1. Purchase and Sale of Stock. Subject to the terms and conditions of this Agreement, the Corporation hereby agrees to sell to the Purchaser and the Purchaser agrees to purchase from the Corporation on the Closing Date (as herein defined) _____ (___) shares of Restricted Stock (the “Stock”) at a price of___ ($___) per share, for an aggregate purchase price of ___ ($___). The purchase price for the Stock shall be paid in cash.

2. Closing. The purchase and sale of the Stock shall occur at a Closing to be held at such time and place (the “Closing Date”), as designated by the Corporation by written notice to the Purchaser of at least one (1) business day prior to the Closing Date. The Closing will take place at the principal office of the Corporation or at such other place as shall be designated by the Corporation. At the Closing, the Purchaser shall deliver to the Corporation a check payable to the order of the Corporation in the aggregate amount of the purchase price of the Stock, and the Corporation will issue, as promptly thereafter as practicable, a certificate representing the Stock registered in the name of the Purchaser.

3. Purchase Option.

(a) All of the Stock shall be subject to the right and option of the Corporation to repurchase the Stock (the “Purchase Option”) as set forth in this Section 3. In the event of the Purchaser’s Termination of Service as an Employee for any reason other than death or Disability (as defined below), the Purchase Option shall come into effect. For purposes of this Agreement, “Disability” shall mean that the Purchaser is “disabled” within the meaning of Section 409A of the Code. Following the Purchaser’s Termination of Service for any reason other than death or Disability, the Corporation shall have the right, as provided in subparagraph (b) hereof, to purchase from the Purchaser or his or her personal representative, as the case may be, at the purchase price per share originally paid as set forth in Section 1 hereof (the “Option Price”), a portion of the Stock computed as follows:

| **If the Termination Occurs:** | **Percentage of Stock Subject to Purchase Option** |
|---|---|
| Prior to January 1, 20__ | 100.00 |
| Between January 1, 20__ and January 1, 20__ | 75.00 |
| Between January 1, 20__ and January 1, 20__ | 50.00 |
| Between January 1, 20__ and January 1, 20__ | 25.00 |

(b) Within 90 days following the Purchaser's Termination of Service for any reason other than death or Disability, the Corporation shall notify the Purchaser by written notice delivered or mailed as provided in subparagraph 10(c), as to whether it wishes to purchase the Stock pursuant to exercise of the Purchase Option. If the Corporation (or its assignee) elects to purchase the Stock hereunder, it shall set a date for the closing of the transaction at a place and time specified by the Corporation, or, at the Corporation's option, such closing may be consummated by mail as provided in Section 10(c) hereof. At such closing, the Corporation (or its assignee) shall tender payment for the Stock and the shares of Stock so purchased shall be returned to the status of authorized but unissued shares. The Option Price shall be payable in cash or by check.

4. Arrangement Regarding Payment of Withholding Tax. Section 12.2 of the Plan requires that recipients of awards under the Plan make arrangements satisfactory to the Administrator regarding payment of federal, state or local taxes of any kind required by law or to be withheld with respect to awards. The Purchaser hereby agrees with the Administrator and the Corporation with respect to any withholding taxes required to be paid upon the lapse of the Purchase Option under the Agreement as follows:

(i) unless the Purchaser otherwise directs the Corporation in writing at least five (5) business days prior to the date of any lapse of the Purchase Option with respect to shares of the Stock, payment of all withholding taxes for each lapse of the Purchase Option shall be made by the assignment by the Purchaser to the Corporation of such number of shares of Stock as to which the Purchase Option is lapsing sufficient in value to fully cover the tax payment due, with the shares being valued for such purpose at the closing price on the last trading day prior to the date of the lapse and any fractional share value in excess of the tax payment due to be paid in cash to the Purchaser; or

(ii) to the extent otherwise directed by the Purchaser, payment of withholding taxes may be made through deduction from salary or other payments due to the Purchaser or through such other method as may be requested by the Purchaser and acceptable to the Administrator.

The Purchaser hereby authorizes and directs the Secretary or Transfer Agent of the Corporation to transfer on the stock ledger of the Corporation the shares of Stock which are to be applied to the payment of taxes from the Purchaser to the Corporation.

5. Adjustments. The Stock is subject to adjustment and modification in certain events as provided in this Agreement and Article 14 of the Plan.

6. Restriction on Transfer. The Purchaser shall not sell, transfer, pledge, hypothecate or otherwise dispose of any shares of the Stock which remain subject to the Purchase Option.

The Corporation shall not be required (i) to transfer on its books any shares of Stock which shall have been sold or transferred in violation of any of the provisions set forth in this Agreement, or (ii) to treat as owner of such shares or to accord the right to vote as such owner or to pay dividends to any transferee to whom such shares shall have been so transferred.

For a period of 90 days following the date any shares of the Stock cease to be subject to the Purchase Option, upon the request of the Purchaser or the Purchaser's personal representative, the Corporation will purchase all or such portion of such shares as is requested, at the Fair Market Value thereof on the date such request is received by the Corporation.

7. Legend. All certificates representing any of the shares of Stock subject to the provisions of this Agreement shall have endorsed thereon the following legend:

"THE TRANSFERABILITY OF THIS CERTIFICATE AND THE SHARES OF STOCK REPRESENTED HEREBY ARE SUBJECT TO THE TERMS AND CONDITIONS (INCLUDING FORFEITURE) OF THE REDWOOD TRUST, INC. 2014 INCENTIVE AWARD PLAN AND A RESTRICTED STOCK AWARD AGREEMENT OR PERFORMANCE SHARE AWARD AGREEMENT ENTERED INTO AND BETWEEN THE REGISTERED OWNER AND REDWOOD TRUST, INC. COPIES OF SUCH PLAN AND AGREEMENT ARE ON FILE IN THE OFFICES OF REDWOOD TRUST, INC."

8. Purchaser's Representations. In connection with the Purchaser's purchase of the Stock, the Purchaser hereby represents and warrants to the Corporation as follows:

(a) Investment Intent; Capacity to Protect Interests. The Purchaser is purchasing the Stock solely for the Purchaser's own account for investment and not with a view to or for sale in connection with any distribution of the Stock or any portion thereof and not with any present intention of selling, offering to sell or otherwise disposing of or distributing the Stock or any portion thereof in any transaction other than a transaction exempt from registration under the Act. The Purchaser also represents that the entire legal and beneficial interest of the Stock is being purchased, and will be held, for the Purchaser's account only, and neither in whole nor in part for any other person. The Purchaser either has a preexisting business or personal relationship with the Corporation or any of its officers, directors or controlling persons or by reason of the Purchaser's business or financial experience or the business or financial experience of the Purchaser's professional advisors who are unaffiliated with and who are not compensated by the Corporation or any affiliate or selling agent of the Corporation, directly or indirectly, could be reasonably assumed to have the capacity to evaluate the merits and risks of an investment in the Corporation and to protect the Purchaser's own interests in connection with this transaction.

(b) Residence. The Purchaser's principal residence is located at the address indicated beneath the Purchaser's signature below.

(c) Limitations on Disposition. Without in any way limiting the Purchaser's representations set forth above, the Purchaser further agrees that he or she shall in no event make any disposition of all or any portion of the Stock unless and until:

(i) The shares of Stock proposed to be transferred are no longer subject to the Purchase Option set forth in Section 3; and

(ii) If the Purchaser is an affiliate of the Corporation, the disposition is made pursuant to an effective registration statement or pursuant to Rule 144 or is otherwise exempt from registration requirements in the opinion of counsel acceptable to the Corporation.

(d) Section 83(b) Election. The Purchaser understands that Section 83 of the Internal Revenue Code of 1986, as amended (the "Code"), taxes as ordinary income the difference between the amount paid for the Stock (if any) and the fair market value of the Stock as of the date any restrictions on the Stock lapse. In this context, "restriction" means the right of the Corporation to buy back the stock pursuant to the Purchase Option. The Purchaser understands that the Purchaser may elect to be taxed for federal income tax purposes at the time the Stock is purchased rather than when and as the Purchase Option lapses by filing an election under Section 83(b) of the Code with the I.R.S. within thirty (30) days from the date of purchase. The form for making this election is attached as Exhibit A hereto. The Purchaser further understands that the Purchaser may suffer adverse tax consequences as a result of the Purchaser's acquisition, holding (including upon vesting) or disposition of the Stock. The Purchaser represents that the Purchaser has consulted with any tax consultants the Purchaser deems advisable in connection with the acquisition or disposition of the Stock and that no action or representation by the Corporation shall be construed as the giving of tax advice and the Purchaser is not relying on the Corporation for any tax advice.

THE PURCHASER ACKNOWLEDGES THAT IT IS THE PURCHASER'S SOLE RESPONSIBILITY AND NOT THE CORPORATION'S TO FILE TIMELY AN ELECTION UNDER INTERNAL REVENUE CODE SECTION 83(b) AND UNDER ANY CORRESPONDING PROVISIONS OF STATE TAX LAW IF THE PURCHASE ELECTS TO MAKE SUCH A FILING, EVEN IF THE PURCHASER REQUESTS THE CORPORATION OR ITS REPRESENTATIVES TO MAKE THIS FILING ON THE PURCHASER'S BEHALF. THE PURCHASER FURTHER ACKNOWLEDGES AND UNDERSTAND THAT THE PURCHASER SHALL BE REQUIRED TO SATISFY AND SHALL BE SOLELY LIABLE FOR ALL APPLICABLE FEDERAL, STATE, LOCAL AND FOREIGN TAX WITHHOLDING OBLIGATIONS ASSOCIATED WITH THE STOCK AND THE PURCHASER HEREBY AGREES TO PAY SUCH WITHHOLDING AMOUNTS TO THE CORPORATION AT SUCH TIMES AND IN SUCH FORM AS THE CORPORATION SHALL REQUIRE FOR PURPOSES OF TIMELY SATISFYING SUCH WITHHOLDING OBLIGATIONS.

9. Escrow. As security for the faithful performance of the terms of this Agreement and to ensure the availability for delivery of the Purchaser's Stock upon exercise of the Purchase Option herein provided for, the Purchaser agrees to deposit with the Secretary of the Corporation, or such other person designated by the Corporation, as escrow agent in this transaction (the "Escrow Agent"), the Stock, to be held by the Escrow Agent and delivered by said Escrow Agent pursuant to the Joint Escrow Instructions of the Corporation and the Purchaser set forth in Exhibit B attached hereto and incorporated by this reference, which instructions shall also be delivered to the Escrow Agent at the closing hereunder.

10. Miscellaneous.

(a) Subject to the provisions and limitations hereof, the Purchaser shall have, during the term of this Agreement, exercise all rights and privileges of a stockholder of the Corporation with respect to the Stock deposited in said escrow.

(b) The parties agree to execute such further instruments and to take such further action as may reasonably be necessary to carry out the intent of this Agreement.

(c) Any notice required or permitted hereunder shall be given in writing and shall be deemed effectively given upon personal delivery or upon deposit in the United States Post Office, by registered or certified mail with postage and fees prepaid, addressed to the Purchaser at his address shown on the Corporation's employment records and to the Corporation at the address of its principal corporate offices (attention: Secretary) or at such other address as such party may designate by ten days' advance written notice to the other party hereto.

(d) The Corporation may assign its rights and delegate its duties under this Agreement, including paragraphs 3 and 6 hereof. If any such assignment or delegation requires consent of any state securities authorities, the parties agree to cooperate in requesting such consent. This Agreement shall inure to the benefit of the successors and assigns of the Corporation and, subject to the restrictions on transfer herein set forth, be binding upon the Purchaser, his or her heirs, executors, administrators, successors and assigns.

(e) The Purchaser hereby authorizes and directs the Secretary or Transfer Agent of the Corporation to transfer the Stock as to which the Purchase Option has been exercised from the Purchaser to the Corporation.

(f) Nothing in this Agreement shall affect in any manner whatsoever the right or power of the Corporation, or a parent or subsidiary of the Corporation, to terminate the Purchaser's employment or other service relationship, for any reason, with or without cause.

(g) The failure of the Corporation to enforce at any time any provision on this Agreement shall in no way be construed to be a waiver of such provision or of any other provision hereof.

(h) The Plan is hereby incorporated by reference and made a part hereof, and this Agreement is subject to all terms and conditions of the Plan.

(i) This Agreement does not supersede nor does it modify any existing agreements between the Purchaser and the Corporation.

(j) This Agreement may be amended or modified at any time by an instrument in writing signed by the parties hereto.

IN WITNESS WHEREOF, the parties have executed this Agreement on the day and year first above written.

**REDWOOD TRUST, INC.**

By: ______________________________

Andrew P. Stone
General Counsel & Secretary
One Belvedere Place, Suite 300
Mill Valley, CA 94941

The undersigned hereby accepts and agrees to all the terms and provisions of this Agreement and to all the terms and provisions of the Plan herein incorporated by reference.

______________________________

[Insert Participant Name]
c/o Redwood Trust, Inc.
One Belvedere Place, Suite 300
Mill Valley, CA 94941

**Exhibit 10.5**

**FIFTH AMENDMENT TO**
**AMENDED AND RESTATED EMPLOYMENT AGREEMENT**

**THIS FIFTH AMENDMENT TO EMPLOYMENT AGREEMENT** (this "Agreement"), is entered into as of the 6th day of August 2014 (the "Effective Date") by and between **MARTIN S. HUGHES** (the "Executive") and **REDWOOD TRUST, INC.,** a Maryland Corporation (the "Company").

**WHEREAS**, the Executive and the Company have entered into an Amended and Restated Employment Agreement dated as of March 31, 2009 (as subsequently amended as of March 17, 2010, February 24, 2011, May 17, 2012, and December 14, 2012, the "Employment Agreement"); and

**WHEREAS**, the Executive and the Company desire to enter into this Agreement for purposes of amending the Employment Agreement as set forth herein;

**NOW, THEREFORE**, for good and valuable consideration, the receipt and adequacy which is hereby acknowledged, the Executive and the Company hereby agree that the Employment Agreement is hereby amended as follows effective upon the Effective Date:

(1) Section 3(a) of the Employment Agreement shall be amended, effective as of January 1, 2014, to replace the base salary amount of "$700,000" specified therein with "$725,000".

Except as hereby specifically amended or modified, the terms of the Employment Agreement, as amended by this Agreement, shall remain in full force and effect. This Agreement may be executed by the parties hereto in two counterparts, each of which shall be an original and all of which together shall constitute one and the same agreement. This Agreement shall be governed in all respects by the laws of the State of California (without regard to conflict of law principles).

**IN WITNESS WHEREOF**, the Company has caused this Agreement to be executed by its duly authorized officer, and the Executive has executed this Agreement, as of the date first above written.

**REDWOOD TRUST, INC.**

By: /s/ ANDREW P. STONE
Name: Andrew Stone
Title: General Counsel & Secretary

**MARTIN S. HUGHES**

/s/ MARTIN S. HUGHES

**Exhibit 10.6**

**FIFTH AMENDMENT TO**
**AMENDED AND RESTATED EMPLOYMENT AGREEMENT**

**THIS FIFTH AMENDMENT TO EMPLOYMENT AGREEMENT** (this "Agreement"), is entered into as of the 6th day of August 2014 (the "Effective Date") by and between **BRETT D. NICHOLAS** (the "Executive") and **REDWOOD TRUST, INC.,** a Maryland Corporation (the "Company").

**WHEREAS**, the Executive and the Company have entered into an Amended and Restated Employment Agreement dated as of March 31, 2009 (as subsequently amended as of March 17, 2010, February 24, 2011, May 17, 2012, and December 14, 2012, the "Employment Agreement"); and

**WHEREAS**, the Executive and the Company desire to enter into this Agreement for purposes of amending the Employment Agreement as set forth herein;

**NOW, THEREFORE**, for good and valuable consideration, the receipt and adequacy which is hereby acknowledged, the Executive and the Company hereby agree that the Employment Agreement is hereby amended as follows effective upon the Effective Date:

(1) Section 3(b) of the Employment Agreement shall be amended to replace the target annual bonus percentage of "160%" specified therein with "165%".

Except as hereby specifically amended or modified, the terms of the Employment Agreement, as amended by this Agreement, shall remain in full force and effect. This Agreement may be executed by the parties hereto in two counterparts, each of which shall be an original and all of which together shall constitute one and the same agreement. This Agreement shall be governed in all respects by the laws of the State of California (without regard to conflict of law principles).

**IN WITNESS WHEREOF**, the Company has caused this Agreement to be executed by its duly authorized officer, and the Executive has executed this Agreement, as of the date first above written.

**REDWOOD TRUST, INC.**

By: /s/ MARTIN S. HUGHES
Name: Martin S. Hughes
Title: Chief Executive Officer

**BRETT D. NICHOLAS**

/s/ BRETT D. NICHOLAS

# SECOND AMENDMENT TO LEASE

**THIS SECOND AMENDMENT TO LEASE** (this "**Second Amendment**") is entered into effective as of this 23rd day of June, 2014 (the "**Second Amendment Date**"), by and between MG-POINT, LLC, a Colorado limited liability company (" **Landlord**"), and REDWOOD TRUST, INC., a Maryland corporation ("**Tenant**").

## RECITALS:

**A.** WHEREAS, Landlord and Tenant entered into that certain Office Lease dated January 11, 2013, as amended by that certain First Amendment to Lease dated June 27, 2013 (collectively, the "**Lease**") relating to the leasing of certain premises consisting of approximately 21,517 rentable square feet of space in Suite No. 425 (the "**Original Premises**") in the building located at 8310 South Valley Highway, Englewood, Colorado 80112 and commonly known as the "The Point at Inverness" (the "**Building**"), said Original Premises being more particularly described in the Lease;

**B.** WHEREAS, the Term of the Lease is currently set to expire on January 31, 2021, unless terminated earlier pursuant to the Lease (the "**Expiration Date**"); and

**C.** WHEREAS, Landlord and Tenant desire ***(i)*** to expand the Original Premises to include Suite 115 on the 1st floor of the Building, which is an area consisting of approximately 7,215 rentable square feet as shown cross-hatched on **Exhibit A** attached hereto and incorporated herein (the "**First Floor Expansion Space**"), ***(ii)*** to establish the Base Rent and other terms applicable to the First Floor Expansion Space, and ***(iii)*** to amend other terms of the Lease, all subject and pursuant to the terms and conditions set forth below.

## AGREEMENT:

NOW, THEREFORE, for good and valuable consideration the receipt and adequacy of which are hereby acknowledged, Landlord and Tenant agree as follows:

**1.** INCORPORATION OF RECITALS. The foregoing Recitals shall be incorporated as though fully set forth herein.

**2.** FIRST FLOOR EXPANSION AND FIRST FLOOR EXPANSION EFFECTIVE DATE.

**2.1** **Initial First Floor Expansion Term**. Effective as of the date that is one business day after the Second Amendment Date (the "**First Floor Expansion Effective Date**"), the Original Premises is increased from 21,517 rentable square feet to 28,732 rentable square feet by the addition of the First Floor Expansion Space, and from and after the First Floor Expansion Effective Date until the First Floor Expansion Expiration Date (as defined below), as may be extended, the Original Premises and the First Floor Expansion Space, collectively, shall be deemed the "Premises", as defined in the Lease. The parties intend that the Lease Term for the First Floor Expansion Space (the "**First Floor Expansion Term**") shall commence on the First Floor Expansion Effective Date and expire on October 31, 2017 (such date, as may be extended pursuant to Section 2.2 below, the "**First Floor Expansion Expiration Date**"). As of the end of the First Floor Expansion Term, Tenant shall surrender the First Floor Expansion Space to Landlord in accordance with the terms of the Lease. Except as set forth herein, the First Floor Expansion Term shall be on all the same terms and conditions of the Lease, including without limitation, assuming that Tenant has exercised its option to extend the First Floor Expansion Term pursuant to Section 2.2 below, the application of the Renewal Option to the First Floor Expansion Space; provided that Tenant may elect to exclude the First Floor Expansion Space from its Renewal Option.

**2.2** **First Floor Expansion Space Extended Term**. The Original Tenant has a one-time right to extend the First Floor Expansion Term and delay the First Floor Expansion Expiration Date, so that the expiration date for the First Floor Expansion Space shall be co-terminus with the Expiration Date ("**First Floor Extended Term**"), by providing Landlord written notice of Tenant's election to do so no

later than nine (9) months, and no earlier than twelve (12) months, prior to the expiration of the initial First Floor Expansion Expiration Date in which case the terms in which case the terms of the First Floor Extended Term shall be on all the same terms and conditions of the Lease subject to determination of the Market Rate pursuant to Section 4 of the Addendum to the Lease. Notwithstanding the fact that, upon Tenant's exercise of the option to affect the First Floor Extended Term the extension of the Term shall be self-executing, the parties shall, within 15 days after the determination of Market Rent for the First Floor Expansion Space, execute one or more amendments to the Lease reflecting such extended term.

3. **Rent and Other Terms**.

**3.1** **Base Rent**. Tenant shall pay Base Rent for the First Floor Expansion Space during the First Floor Expansion Term as follows in accordance with the terms of the Lease:

| Period of the First Floor Expansion Term | Annual Base Rent Rate Per Rentable Square Foot | Annualized Base Rent | Monthly Installment of Base Rent |
|---|---|---|---|
| First Floor Expansion Effective Date – Last Day of the Abated Rent Period* | $24.00 | $173,160.00 | $14,430.00 |
| First Day After the Abated Rent Period – 1/31/15 | $24.00 | $173,160.00 | $14,430.00 |
| 2/1/15 – 1/31/16 | $24.50 | $176,767.44 | $14,730.62 |
| 2/1/16 – 1/31/17 | $25.00 | $180,375.00 | $15,031.25 |
| 2/1/17 – 10/31/17 | $25.50 | $183,982.44 | $15,331.87 |

*Subject to the abatement during the Abated Rent Period pursuant to Section 4 below.

**3.2** **Tenant's Additional Rent**.

*(a)* From and after the First Floor Expansion Effective Date, Tenant shall pay additional Rent with respect to the First Floor Expansion Space in accordance with the terms of the Lease, including, without limitation, Tenant's Pro Rata Share of increases in Operating Expenses, computed using a Base Year of 2014 and applying a Tenant's Pro Rata Share of 3.859% to the First Floor Expansion Space. As set forth in Section 3 of the Addendum to the Lease, in no event shall Controllable Operating Expenses with respect to the First Floor Expansion Space for any year during the First Floor Expansion Term increase by more than 5% in excess of Controllable Operating Expenses for the immediately preceding year, on a compounding and cumulative basis; and

*(b)* Tenant shall continue to pay to Landlord, at the time and in the manner set forth in the Lease, Tenant's Base Rent and additional Rent due under the Lease with respect to the Original Premises.

**3.3** **Tenant's Covenant to Pay Rent**. Tenant agrees to pay to Landlord at Landlord's Payment Address, or to such other persons, or at such other places designated by Landlord, without any prior demand therefor in immediately available funds and without any deduction or offset whatsoever, Base Rent and Additional Rent due under the Lease with respect to the Original Premises and the First Floor Expansion Space. Any and all references in the Lease to "Rent" are hereby amended to include reference to all Base Rent and Additional Rent payable with respect to the entire Premises.

**4 . <u>Abated Rent Period</u>**. Tenant's obligation to pay Base Rent and Tenant's Pro Rata Share of increases in Operating Expenses for the First Floor Expansion Space shall be abated during the period commencing on the First Floor Expansion Effective Date and continuing through the date that is 120 days thereafter (the "**<u>Abated Rent Period</u>**"), prorated on a per-diem basis. Only Base Rent and Operating Expenses shall be abated during the Abated Rent Period, and all other costs and charges specified in the Lease shall remain as due and payable pursuant to the provisions of the Lease.

**5 . <u>Additional Deposit</u>**. Upon Tenant's execution hereof, Tenant shall pay Landlord the sum of $7,215.00 which is added to and becomes part of the Deposit held by Landlord as provided under Sections 1.6 and 9 of the Lease as security for payment of Rent and the performance of the other terms and conditions of the Lease by Tenant. Accordingly, simultaneous with the execution hereof, the Deposit is increased from $48,413.25 to $55,628.25.

**6. <u>Condition of the Premises; Allowance</u>**.

**6 . 1 <u>Condition of Premises</u>**. Tenant acknowledges that neither Landlord nor any agent of Landlord has made any representation or warranty with respect to the Original Premises, First Floor Expansion Space, or the Building, or with respect to the suitability of any part of the same for the conduct of Tenant's business. Tenant further acknowledges and agrees that, as of the Second Amendment Date, *(a)* Tenant is in possession of the Original Premises, and *(b)* the Original Premises, First Floor Expansion Space, and the Building are in a good and sanitary order, condition and repair acceptable to Tenant. Tenant shall be conclusively deemed to have accepted the First Floor Expansion Space "***AS IS***" in the condition existing on the First Floor Expansion Effective Date, and to have waived all claims relating to the condition of the First Floor Expansion Space.

**6.2 <u>Allowance</u>**. Tenant may use up to $21,645.00 (the " **Allowance**") for the purchase and installation of data cabling, painting and carpet cleaning within the First Floor Expansion Space. Except as set forth herein, in no event shall the Allowance be used for the purchase of any other equipment, furniture or other items of personal property. The Allowance shall be paid to Tenant or, at Landlord's option, to the order of the contractor or vendor that performed the work or provided the goods, within thirty (30) days following completion of such work and receipt by Landlord of the following, as applicable: (1) receipted bills covering all labor and materials expended and used in the work and (2) full and final waivers of lien. Notwithstanding anything herein to the contrary, Landlord shall not be obligated to disburse any portion of the Allowance during the continuance of an uncured default under the Lease, and Landlord's obligation to disburse shall only resume when and if such default is cured. Any portion of the Allowance which is not used as permitted by this Section 6.2 or is otherwise remaining after October 1, 2014 shall accrue to the sole benefit of Landlord, it being agreed that Tenant shall not be entitled to any credit, offset, abatement or payment with respect thereto.

**7. <u>Parking</u>**. From and after the First Floor Expansion Effective Date, the Lease shall be amended as follows:

**7.1 <u>Spaces</u>**. Landlord and Tenant acknowledge and agree that, in addition to the Parking Spaces previously made available to Tenant under the Lease, during the First Floor Expansion Term, Landlord shall make available to Tenant the use of an additional 30 Parking Spaces on an unreserved basis of which 26 shall be Surface Parking Spaces and 4 shall be Covered Parking Spaces, which brings the total number of Surface Parking Spaces made available to Tenant to 107, and the total number of Covered Parking Spaces to 13. Five (5) of the thirteen (13) Covered Spaces shall be designated as Reserved Covered Spaces.

**7.2 <u>Sections 1.9 and 29</u>**. All other terms and conditions of Sections 1.9 and 29 of the Lease not amended herein shall continue in full force and effect, and the additional Surface Parking Spaces and Covered Parking Spaces made available by Landlord in Section 7.1 above shall be subject to the terms and conditions of Section 29 of the Lease; provided, however, the current rate for the Covered Parking spaces is $100.00 per month per space, subject to annual market adjustments, and the current rate for the Reserved Covered Spaces is $150.00 per month per space subject to annual market adjustments.

**8 .** **FURNITURE**. During the First Floor Expansion Term, Tenant shall have the right to use the furniture and fixtures located in the First Floor Expansion Space free of charge in it's as-is condition and Tenant acknowledges that Landlord makes no warranty or representation of any kind with respect to such furniture and fixtures. On or before the day that is ninety (90) days after First Floor Expansion Effective Date, Tenant shall advise Landlord which furniture, if any, Tenant does not intend to use ("**Furniture Notification**") and Landlord shall remove such furniture within five (5) business days of the Furniture Notification.

**9.** **RIGHT OF FIRST REFUSAL**.

**9.1** **Grant of Option; Conditions**. If at any time during the First Floor Expansion Term any lease for Suites 100, 105, or 145 on the first (1st) floor of the Building shown on the demising plan attached hereto as Exhibit B (the "**Refusal Space**") shall expire and if Landlord intends to enter into a lease for such Refusal Space ("**Proposed Lease**") with any party other than the tenant then occupying the Refusal Space, then Landlord shall first offer to Tenant the right to lease the Refusal Space as part of the Premises upon the terms and conditions of the Proposed Lease (the "**Right of First Refusal**"). Each refusal right of the Refusal Space, whether 100, 105, or 145 shall be independent of each other right to a portion of the Refusal Space. Tenant's Right of First Refusal is an ongoing right effective during the Extension Term and shall be exercised as follows: when Landlord has entered into a written agreement with a prospective tenant, other than the tenant then occupying the Refusal Space (the "**Prospect**") interested in leasing the Refusal Space, Landlord shall advise Tenant (the "**Advice**") of the terms and conditions under which Landlord is prepared to lease the Refusal Space to such Prospect. The Advice shall include any and all other space in the Building (which, for purposes of such Advice, shall be deemed to be part of the Refusal Space) that such Prospect is interested in leasing, and Tenant must exercise this Right of First Refusal, if at all, by accepting all such space in the Building identified in the Advice. Tenant may lease the Refusal Space under such terms by providing Landlord with written notice of exercise (the "**Notice of Exercise**") within 5 business days after the date of the Advice. Tenant shall be deemed to have declined to exercise this Right of First Refusal if its Notice of Exercise is delayed or if the Notice of Exercise changes any term or condition of the Advice. Notwithstanding the foregoing, Tenant shall have no such Right of First Refusal and Landlord need not provide Tenant with an Advice if:

*(a)* an Event of Default is continuing at the time that Landlord would otherwise deliver the Advice; or

*(b)* the Premises, or any portion thereof, is sublet (other than pursuant to a Transfer to a Permitted Transferee, as defined in Section 14.2 of the Lease) at the time Landlord would otherwise deliver the Advice; or

*(c)* the Lease has been assigned (other than pursuant to a Transfer to a Permitted Transferee, as defined in Section 14.2 of the Lease) prior to the date Landlord would otherwise deliver the Advice; or

*(d)* the Refusal Space is not intended for the exclusive use of Tenant during the Term; or

*(e)* Tenant is not occupying the Premises on the date Landlord would otherwise deliver the Advice.

**9.2 Terms for Refusal Space**.

*(a)* Subject to Section 9.03 below, the term for the Refusal Space shall commence upon the Refusal Space Commencement Date (as defined herein) and shall continue for the term stated in the Advice. Upon the Refusal Space Commencement Date, the Refusal Space shall be considered a part of the Premises. Tenant shall pay Rent for the Refusal Space in accordance with the terms and conditions of the Advice and all of the terms stated in the Advice shall govern Tenant's occupancy of the Refusal Space; provided, however, all other non-conflicting terms and conditions of the Lease shall govern Tenant's occupancy of the Refusal Space. The "**Refusal Space Commencement Date**" shall mean the delivery of the Refusal Space by Landlord subject to Substantial Completion of any improvements committed to be performed in the Refusal Space by Landlord pursuant to the Advice.

*(b)* The Refusal Space (including improvements and personalty, if any) shall be accepted by Tenant in its condition and as-built configuration existing on the Refusal Space Commencement Date, unless the Advice specifies additional work to be performed by Landlord in the Refusal Space after the Refusal Space Commencement Date, in which case Landlord shall perform such work in the Refusal Space. If Landlord is delayed delivering possession of the Refusal Space due to the holdover or unlawful possession of such space by any party, Landlord shall use reasonable efforts to obtain possession of the space, and the Refusal Space Commencement Date shall be postponed until the date Landlord delivers possession of the Refusal Space to Tenant free from occupancy by any party.

*(c)* Landlord reserves the right upon receipt of the Notice of Exercise to request Tenant's current financial records in a form reasonably acceptable to Landlord, to review Tenant's current financial condition and to adjust the security required under the Advice as reasonably determined by Landlord.

**9.3 Termination of Right of First Refusal**. The rights of Tenant hereunder with respect to each Refusal Space shall terminate on the date Landlord would have provided Tenant an Advice with respect to any portion of the Refusal Space if Tenant had not been in violation of one or more of the conditions set forth in Section 9.1 above.

**9.4 Refusal Space Amendment**. If Tenant exercises its Right of First Refusal, Landlord shall prepare an amendment to the Lease (the "**Refusal Space Amendment**") adding the Refusal Space to the Premises on the terms set forth in the Advice and reflecting the changes in the Base Rent, rentable square footage of the Premises, Tenant's Pro Rata Share and other appropriate terms. A copy of the Refusal Space Amendment shall be sent to Tenant within a reasonable time after Landlord's receipt of the Notice of Exercise, and Tenant shall execute and return the Refusal Space Amendment to Landlord within 10 days thereafter and Landlord shall promptly counter execute and return same to Tenant, but an otherwise valid exercise of the Right of First Refusal shall be fully effective whether or not the Refusal Space Amendment is executed.

**9.5 Subordination**. Notwithstanding anything herein to the contrary, Tenant's Right of First Refusal is subject and subordinate to (i) any tenant leasing all or any portion of the Refusal Space as of the date of the Lease; (ii) the expansion rights (whether such rights are designated as a right of first offer, right of first refusal, expansion option or otherwise) of any tenant of the Building regarding the Refusal Space existing on the date of the Lease; (iii) the right of Landlord to lease the space to any other tenant or tenant prospect who by the inclusion of the Refusal Space will occupy more space in the Building than Tenant; and (iv) Landlord's right to retain the use of the space for its own internal use, including but not limited to use by an affiliate or subsidiary of Landlord or use as a management office.

**9.6 Original Tenant**. The Right of First Refusal shall be personal to Original Tenant (as defined in the Lease), and may only be exercised by Original Tenant. All references to "Tenant" in this Section 9 shall mean Original Tenant only. In the event of any assignment of the Lease or sublease of all or any portion of the Premises to any party other than Original Tenant, the Right of First Refusal shall be extinguished.

## 10. **<u>CONDITIONAL ACCELERATION OF TERMINATION DATE</u> .**

**10.1 <u>Accelerated Termination Right</u>**. Tenant shall have a one-time right to terminate the Lease with respect to the First Floor Expansion Space only ("**<u>Acceleration Option</u>**") any time during the First Floor Expansion Term if Tenant is able to relocate its employees from the First Floor Expansion Premises to all or a portion of the space on the 4th Floor of the Building currently leased to Intermap Technologies, Inc. ("**<u>Intermap Premises</u>**"), by entering into a new lease with Landlord for all or a portion of the Intermap Premises effective as of the commencement date of Tenant's occupancy of the Intermap Premises (the "**<u>Accelerated Termination Date</u>**"), subject to the following terms and conditions.

*(a)* Landlord shall have received written notice of Tenant's election to exercise its Acceleration Option (the "**<u>Acceleration Notice</u>**") on or before the date that the parties execute a lease agreement (or amendment) granting Tenant occupancy rights for the Intermap Premises along with payment in full of the Termination Fee (as defined below).

*(b)* There is no Event of Default under the Lease as of the date Tenant provides Landlord an Acceleration Notice or from or after the date of such notice.

*(c)* No part of Premises is sublet for a term extending past the Accelerated Termination Date.

*(d)* The Lease has not been assigned other than pursuant to a Permitted Transfer.

*(e)* The Lease Term has not been extended beyond the initial Expiration Date.

**10.2 <u>Termination Fee</u>**. As consideration for and a condition of Tenant's right to exercise its Acceleration Option, Tenant shall pay to Landlord an amount (the "**<u>Termination Fee</u>**") equal to the sum of the unamortized portion of the leasing commissions incurred by Landlord in connection with this Second Amendment (which the parties agree is $21,645.00) as of the Accelerated Termination Date amortized over the First Floor Expansion Term on a straight line basis with no interest. Tenant shall pay the Termination Fee to Landlord simultaneously with the delivery of the Acceleration Notice. Tenant shall remain liable for all Base Rent, Additional Base Rent and other sums due under the Lease up to and including the Accelerated Termination Date even though billings for such may occur subsequent to the Accelerated Termination Date.

**10.3 <u>Terms and Conditions</u>**.

*(a)* Provided Tenant has performed in accordance herewith and Landlord has received the Termination Fee as set forth above, the Lease with respect to Suite 115 shall automatically terminate as of 5:00 p.m. on the Accelerated Termination Date and neither party shall have any further obligation or liability to the other except for (i) the obligation with respect to actual Operating Expenses which shall survive Termination and shall be paid in accordance with the terms of the Lease, (ii) any indemnification waivers or releases by either party of the other for claims or liability accruing or arising prior to the Accelerated Termination Date, which indemnification, waivers or releases shall survive termination including but not limited to the provisions of Section 12.3 of the Lease and (iii) any other provision which by its terms survives termination.

*(b)* Time is of the essence hereof. If Tenant fails to deliver notice of its election to terminate in accordance herewith, the Accelerated Termination right shall be automatically null and void and of no further force and effect.

*(c)* If Tenant has given proper and timely notice of its election to terminate but otherwise commits or permits an Event of Default, including without limitation failure to pay the Termination Fee or surrender the Premises on the Accelerated Termination Date in accordance with the terms of the Lease, Landlord at its option may without waiving any rights or remedy for such default elect to either (i) declare this Accelerated Termination right null and void and the Lease shall continue in full force and effect or (ii) terminate the Lease pursuant to Section 17 of the Lease and recover all damages including consequential damages arising from Tenant having defaulted hereunder. Nothing herein shall be deemed to prohibit Landlord from recovering the Termination Fee, if not paid by Tenant, together with interest thereon and the late payment fee.

*(d)* Tenant shall keep and perform its obligations under the Lease through the Accelerated Termination Date and shall surrender the First Floor Expansion Space no later than noon on the Accelerated Termination Date in accordance with the terms of the Lease.

**10.4** **Original Tenant**. The Acceleration Option shall be personal to Original Tenant (as defined in the Lease), and may only be exercised by Original Tenant. All references to "Tenant" in this Section 10 shall mean Original Tenant only. In the event of any assignment of the Lease or sublease of all or any portion of the Premises to any party other than Original Tenant, the Acceleration Option shall be extinguished.

**11.** **Brokerage**. Tenant represents it has not dealt with or employed any broker in connection with the negotiation, execution and delivery of this Second Amendment and has no knowledge of any broker's involvement in this transaction except those listed in Sections 1.15 and 1.16 of the Lease (collectively, the "**Brokers**"). Landlord and Tenant shall each indemnify the other against any expense incurred by the other as a result of any claim for commissions or fees by any other broker, finder, or agent, whether or not meritorious, employed by the other or claiming by, through, or under the other, other than the Brokers. Tenant acknowledges Landlord is not liable for any representations by the Brokers regarding the Premises, Building, Building Complex, or this Lease.

**12.** **Signage**. Landlord will provide Tenant, at Landlord's cost and expense, standard signage on the Building lobby directory and building standard suite signage at the entry to the First Floor Expansion Space to identify Tenant and Redwood Residential Acquisition Corporation (or another of Tenant's affiliates as approved by Landlord such approval not to be unreasonably withheld or delayed).

**13.** **General Provisions**.

**13.1** **Full Force and Effect; Conflict**. Except as amended by this Second Amendment, the Lease as modified herein remains in full force and effect and is hereby ratified by Landlord and Tenant. In the event of any conflict between the Lease and this Second Amendment, the terms and conditions of this Second Amendment shall control.

**13.2** **Capitalized Terms**. Capitalized terms not defined herein shall have the same meaning as set forth in the Lease.

**13.3** **Governing Law**. This Second Amendment shall be governed by and construed in accordance with the laws of the State of Colorado.

**13.4** **Attorneys' Fees**. In the event of litigation arising out of or in connection with this Second Amendment, the prevailing party shall be awarded reasonable attorneys' fees, costs and expenses.

**13.5** **Successors and Assigns**. This Second Amendment shall be binding upon and inure to the benefit of the parties hereto and their heirs, personal representatives, successors and assigns.

**13.6** **Entire Agreement**. The Lease, as amended by this Second Amendment, contains the entire agreement of Landlord and Tenant with respect to the subject matter hereof, and may not be amended or modified except by an instrument executed in writing by Landlord and Tenant.

**13.7** **Power and Authority**. Except as provided herein, Tenant has not assigned or transferred any interest in the Lease and has full power and authority to execute this Second Amendment.

**13.8** **Counterparts**. This Second Amendment may be executed in any number of counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

**13.9** **Facsimile/PDF Signatures**. This Second Amendment may be executed by facsimile and/or .pdf signatures which shall be binding as originals on the parties hereto.

**13.10** **No Option**. The submission of this document for examination and review does not constitute an option, an offer to lease space in the Building or an agreement to lease. This document shall have no binding effect on the parties unless and until executed by both Landlord and Tenant and will be effective only upon Landlord's execution of the same.

**13.11** **Disclosure**. The parties hereto hereby acknowledge and agree that all information related to this Second Amendment may be publically disclosed by Tenant without the prior written consent of Landlord to the extent necessary to comply with any law, rule or regulation (including, without limitation, any rule or regulation promulgated by the SEC) or the valid order of any governmental agency or any court of competent jurisdiction.

*[signature page follows]*

**IN WITNESS WHEREOF**, Landlord and Tenant have caused this Second Amendment to be executed as of the Second Amendment Date.

**LANDLORD:**

MG-POINT, LLC,
a Colorado limited liability company

By: /s/ Peter W. Savoie

Name: Peter W. Savoie
Title: Authorized Signatory

**TENANT:**

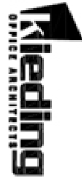
REDWOOD TRUST, INC.,
a Maryland corporation

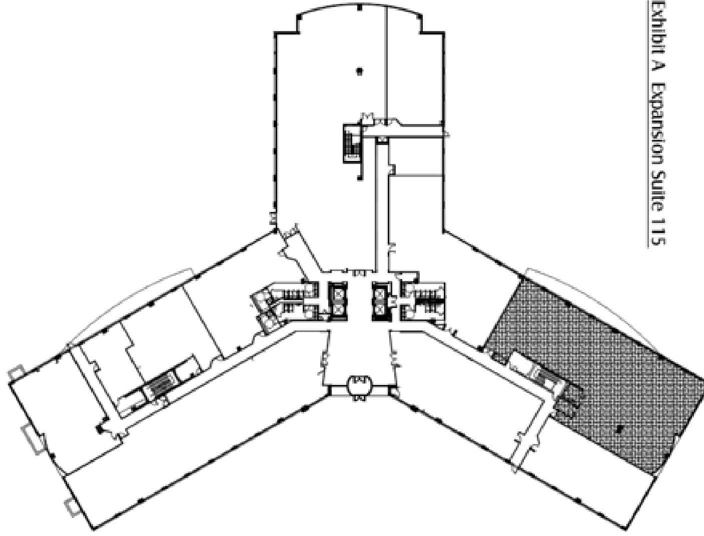
By: /s/ E. Todd Whittemore

Name: E. Todd Whittemore

Title: Managing Director

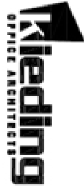
Exhibit A
to
Second Amendment to Lease
<u>Depiction of First Floor Expansion Space</u>

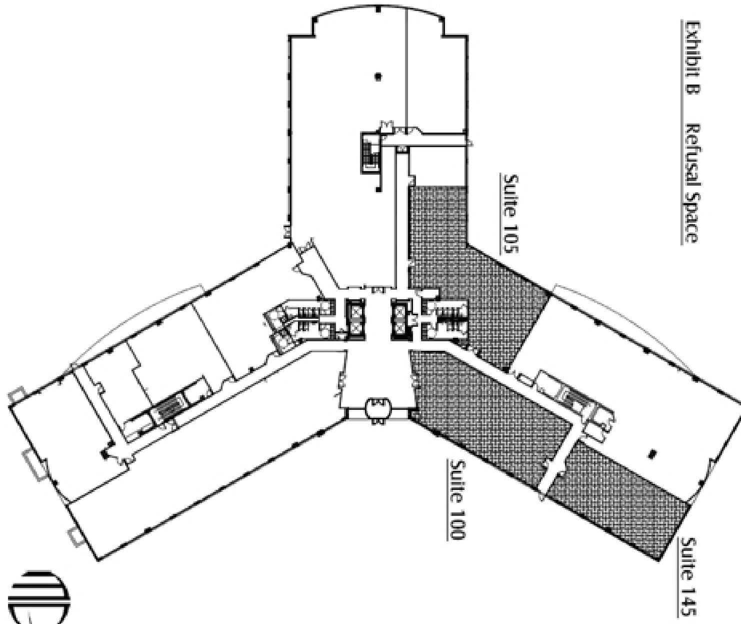





POINT AT INVERNESS
Expansion Suite
First Floor
Not To Scale
June 3, 2014

Exhibit B
to
Second Amendment to Lease
<u>Refusal Space</u>



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Refusal Space
First Floor
Not To Scale
June 3, 2014

Newmark Knight Frank
Frederick Ross

FEDERAL HOME LOAN BANK OF CHICAGO
ADVANCES, COLLATERAL PLEDGE, AND SECURITY AGREEMENT
[Insurance Companies]
[Nonstandard – RWT Financial, LLC]

THIS AGREEMENT, dated as of July 16, 2014 between the FEDERAL HOME LOAN BANK OF CHICAGO, with its principal office located at 200 East Randolph Drive, Chicago, Illinois 60601 ("Bank") and RWT FINANCIAL, LLC, a Delaware limited liability company, authorized by the Delaware Insurance Commissioner as a special purpose captive insurance company pursuant to Certificate of Authority dated April 24, 2014 ("Member"), organized under the laws of Delaware, and having its chief executive office at 155 North Wacker Drive, Suite 4250, Chicago, Illinois 60606.

WHEREAS, the Member desires from time to time to participate in the Bank's credit programs under the terms of this Agreement (as hereinafter defined) and the Bank is authorized to make advances to the Member, subject to the provisions of the Credit Policy (as hereinafter defined), the Federal Home Loan Bank Act, as now and hereafter amended (the "Act"), and the regulations and guidelines of the Federal Housing Finance Agency (or any successor thereto), as now and hereafter in effect (collectively, the "Regulations"); and

WHEREAS, the Bank requires that advances and other obligations owed by the Member to the Bank be secured pursuant to this Agreement, and the Member agrees to provide the collateral security the Bank requests in accordance with this Agreement and to otherwise comply with the requirements hereof and the Bank's Credit Policy.

NOW THEREFORE, the Member and Bank agree as follows:

ARTICLE I
DEFINITIONS

Section 1.01 DEFINITIONS. As used herein, the following terms shall have the following meanings:

(a) "Additional Collateral" means items of property other than Eligible Collateral which are pledged by the Member and accepted by the Bank as collateral, as it deems necessary, to fully secure and protect the Bank's security position on outstanding Advances or to renew an outstanding Advance in accordance with Section 10(a)(4) of the Act (12 U.S.C. § 1430(a)(4), as amended) and any Regulations adopted thereunder.

(b) "Advance" or "Advances" means any and all loans, overdrafts, or other extensions of credit, including, without limitation, deposits under funding agreements, and all Outstanding Commitments, whether now or hereafter granted by the Bank to, on behalf of, or for the account of, the Member in accordance with such terms and conditions as are applicable to each such transaction as set forth in the Credit Policy (but excluding any obligations that the Bank may now or hereafter have to honor items or transfer orders under a depository or similar agreement between the Member and the Bank).

(c) "Affiliate" means with respect to the Member, any other person or entity controlling or controlled by or under common control with the Member. For purposes of this definition, "control" when used with respect to any specified person (including the Member) means the power to direct the management and policies of such person or entity, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise; provided that, and for the avoidance of doubt, notwithstanding the foregoing definition of "Affiliate" none of the following shall be considered an Affiliate of the Member: (i) Acacia CDO 5, Ltd. or Acacia CDO 5, Inc.; (ii) Acacia CDO 6,. Ltd. or Acacia CDO 6, Inc.; (iii) Acacia CDO 7, Ltd. or Acacia CDO 7, Inc.; (iv) Acacia CDO 8, Ltd. or Acacia CDO 8, Inc.; (v) Acacia CRE CDO 1, Ltd. or Acacia CRE CDO 1, Inc.; (vi) Acacia CDO 9 Ltd. or Acacia CDO 9, Inc.; (vii) Acacia CDO 10, Ltd. or Acacia CDO 10; Inc.; (viii) Acacia CDO 11, Ltd. or Acacia CDO 11, Inc.; (ix) Acacia CDO 12, Ltd. or Acacia CDO 12, Inc.; (x) Acacia Option ARM 1 CDO, Ltd. or Acacia Option ARM 1 CDO Corp.; or (xi) any securitization trust or resecuritization trust established in connection with the issuance of any mortgage-backed securities, any collateralized loan obligations, any asset-backed commercial paper or any other asset-backed securities.

(d) "Agreement" means this Advances, Collateral Pledge, and Security Agreement, together with any and all permitted and authorized amendments, modifications, or restatements hereof as may be duly entered into by the parties hereto and all documents or other agreements incorporated by reference including, but not limited to, the Credit Policy.

(e) "Application" means a written or electronic submission (or if so specified in the Credit Policy, may be telephonic to the Bank), in such form and submitted in such manner as may be specified by the Bank from time to time in the Credit

Policy or by notice to the Member, by which the Member requests an Advance or a Commitment for an Advance, including, without limitation, in the case of a deposit under a funding agreement, a placement schedule or similar addendum or endorsement to the funding agreement.

(f) “Capital Stock” means all of the Member’s capital stock issued by the Bank and all payments which have been or hereafter are made on account of subscriptions to and all unpaid dividends on such capital stock.

(g) [Reserved].

(h) “Collateral” means: (1) all property, including the proceeds thereof, heretofore assigned, transferred, or pledged to the Bank by the Member, or in which the Member has granted the Bank a security interest, to secure Advances and other Indebtedness and (2) all Eligible Collateral and Additional Collateral, including the proceeds thereof, which is now or hereafter assigned, transferred, or pledged to the Bank by the Member, or in which the Member now or hereafter grants the Bank a security interest, pursuant to Section 3.01 hereof.

(i) “Collateral Maintenance Level” means a dollar amount of Qualifying Collateral having a Collateral Value equal to such percentage as the Bank may specify from time to time in its Credit Policy of the aggregate dollar amount of (1) Indebtedness and (2) any other amounts specified by the Bank from time to time under the Credit Policy. The Bank may increase or decrease the Collateral Maintenance Level at any time (A) for all Members, as a result of a change in the Credit Policy, upon fifteen (15) business days advance written notice to Member; or (B) for Member, as a result of credit deterioration, upon three (3) business days advance written notice.

(j) “Collateral Value” means an amount equal to such percentage of the market value or unpaid principal balances of items of Collateral as the Bank may specify from time to time, in its sole discretion.

(k) “Commitment” means any obligation of the Bank to make an Advance or payment to, on behalf of, or for the account of, the Member, regardless of whether such obligation is contingent in whole or in part, including, without limitation, on the Bank’s obligations under letters of credit, firm commitments, guarantees, or other arrangements intended to facilitate transactions between the Member and third parties.

(l) [Reserved].

(m) “Confirmation of Advance” means a writing or transmission in electronic or other form as may be determined by the Bank from time to time, by which the Bank agrees to and confirms an Application. With respect to an open line of credit Advance, the posting to a Member’s DID Account Statement or such similar electronic statement shall be deemed to be receipt of a Confirmation of Advance.

(n) “Credit Policy” means, collectively, the Bank’s Member Products & Credit Policy, its Member Products Guide, its Collateral Guidelines and such other documents or publications as may from time to time be specified by the Bank as supplementing the same, as each such document or publication may from time to time be modified by the Bank in its sole discretion and communicated to the Member.

(o) “Deposit Accounts” means the Member’s DID Account and any and all other demand, term, time, savings or similar account maintained by the Member with the Bank.

(p) “DID Account” means the Member’s Daily Investment Deposit Account at the Bank.

(q) “Eligible Collateral” means Capital Stock, First Mortgage Collateral, Securities, Deposit Accounts and Other Real Estate Related Collateral.

(r) “Event of Default” means an Event of Default as defined in Section 4.01 hereof.

(s) “First Mortgage Collateral” means Mortgage Loans (excluding participation or other fractional interests therein), the Mortgage Notes evidencing the Mortgage Loans, the Mortgages securing the Mortgage Loans and all general intangibles and accounts relating to a Mortgage Loan, ancillary security agreements, policies and certificates of insurance or guarantees, rent assignments, FHA mortgage insurance or VA loan guarantee certificates, title insurance policies, evidences of

recordation, applications, underwriting materials, surveys, appraisals, approvals, permits, notices, opinions of counsel, loan servicing rights, loan servicing data, all other electronically created, stored and/or written records or materials relating to the Mortgage Loans, the proceeds of the Mortgage Loans, and any real property or other property obtained through foreclosure, by realizing upon or in settlement of the Mortgage Loans and/or the Mortgages.

(t) "Indebtedness" means all indebtedness, obligations and liabilities of the Member to the Bank arising under or pursuant to this Agreement or any other agreements, now or hereafter outstanding, of the Member to the Bank, including, without limitation, all Advances, Outstanding Commitments, interest, prepayment premiums and all other obligations to pay and liabilities of the Member to the Bank.

(u) "Law" means any law (including common law), constitution, statute, treaty, regulation, rule, ordinance, adjudication, opinion, release, ruling, order, injunction, writ, decree or award of any Official Body.

(v) "Mortgage Loans" means fully-disbursed whole loans evidenced by Mortgage Notes which are secured by Mortgages that constitute a first lien on one-to-four unit dwellings or Multi-Family Properties, and any endorsements or assignments thereof.

(w) "Mortgage Notes" means notes, bonds, or other instruments evidencing Mortgage Loans or any other loans or indebtedness secured by Mortgages.

(x) "Mortgages" means mortgages, deeds of trust and any other security instruments that create a lien on real property and secure Mortgage Notes.

(y) "Multi-Family Property" means residential real property which includes five or more dwelling units and as may be further defined in the Credit Policy.

(z) [Reserved].

(aa) "Official Body" means any federal, state, local or other government or political subdivision or any agency, authority, bureau, central bank, commission, department or instrumentality of either, or any court, tribunal, in each case whether foreign or domestic, that regulates Member or Affiliate.

(bb) "Other Real Estate Related Collateral" means (i) all other loans, lines of credit or indebtedness evidenced by Mortgage Notes, excluding First Mortgage Collateral, but otherwise including without limitation, home equity loans, home improvement loans, subordinate loans, mortgage warehouse lines of credit, real estate construction loans, and other real estate related loans, which Mortgage Notes are secured by Mortgages on commercial property, residential property or by security interests in personal property related to real estate transactions or financing, and (A) all Mortgage Notes or other instruments evidencing such loans, lines of credit or indebtedness, (B) any endorsements and assignments thereof to the Member, and (C) all ancillary security agreements, policies and certificates of insurance or guarantees, chattel paper, electronic chattel paper, evidences of recordation, applications, underwriting materials, appraisals, notices, opinions of counsel, loan servicing rights, loan servicing data, and all other electronically stored and written records or materials relating to the loans evidenced or secured thereby, (ii) all property relating to the Member's management, collection, processing, accounting for, monitoring, or servicing of loans and accounts, including, without limitation, all checks, instruments, documents, certificates, agreements, loan accounts, payments, chattel paper, electronic chattel paper, collections, account statements, computer files, records, promissory notes, endorsements, assignments, and loan servicing data, together with the rights, remedies, and powers related thereto, and (iii) participations in or portions of First Mortgage Collateral and participations in or portions of other real estate related collateral as set forth in clause (i) above.

(cc) "Outstanding Commitment(s)" means, at any time, the maximum aggregate amount that the Bank may be obligated to pay or advance under any Commitment.

(dd) "Qualifying Collateral" means Collateral other than Capital Stock that: (1) qualifies as security for Advances under the terms and conditions of the Credit Policy, the Act, and the Regulations and satisfies the requirements for Qualifying Collateral that may be established by the Bank and (2) is owned by the Member free and clear of any liens, encumbrances, or other interests other than may be approved in writing by the Bank.

(ee) “RBC Level” means the level of Risk-Based Capital as determined from time to time in accordance with the most restrictive, as of the date of determination, of the following: (1) state insurance law applicable to the Member; and (2) the policies and procedures of the state insurance department having regulatory authority over the Member, whether or not having the force or effect of Law, which level, in the case of any of (1) or (2), requires a response by the Member or the state insurance department having regulatory authority over the Member.

(ff) “RBC Plan” means each comprehensive financial plan, including all amendments and modifications thereto, filed by the Member with the state insurance department having regulatory authority over the Member.

(gg) “RBC Report” means the report filed each year by the Member with the state insurance department having regulatory authority over the Member, such report to set forth a detailed calculation of the Member’s RBC Level as of the end of the immediately preceding calendar year.

(hh) [Reserved].

(ii) “Risk-Based Capital” means that calculation, as in effect from time to time, which shall be the most restrictive, as of each date of determination, of the calculations utilized by the following: (1) state insurance Law applicable to the Member; or (2) the policies and procedures of the state insurance department having regulatory authority over the Member, whether or not having the force or effect of Law, which calculation, in the case of any of (1) or (2), determines, among other matters, the sufficiency of capital of the Member.

(jj) [Reserved].

(kk) “Securities” means mortgage-backed securities (including participation certificates) issued by Federal Home Loan Mortgage Corporation or Federal National Mortgage Association, obligations guaranteed by Government National Mortgage Association, consolidated obligations of the Federal Home Loan Bank System and/or obligations issued or guaranteed by the United States or an agency thereof, privately-issued residential mortgage-backed securities, and other securities as may be specified from time to time in the Credit Policy.

(ll) [Reserved].

(mm) [Reserved].

(nn) “Swap Transaction” means any transaction between the Member and Bank that constitutes a “swap agreement” as that term is defined in United States Bankruptcy Code (11 U.S.C. §101(53B) or any successor provision), as amended.

(oo) “UCC” means the Uniform Commercial Code as in effect in the State of Illinois or any other state the laws of which are required to be applied in connection with the perfection or priority of security interests thereunder.

## ARTICLE II
## ADVANCES AGREEMENT

Section 2.01 ADVANCE DOCUMENTATION.

(a) The Member may from time to time request Advances and Commitments for Advances or renewal of an outstanding Advance by completing and submitting an Application to the Bank. The terms of each Advance or Commitment for an Advance shall be conclusively evidenced by this Agreement and by either (1) the Member’s Application when such Application is executed or accepted by the Bank without any change; (2) in the case of a telephonic Application received, completed, or modified by the Bank, by a Confirmation of Advance generated by the Bank; or (3) in the case of an open line of credit Advance, the Member’s DID Account Statement. Unless otherwise agreed to by the Bank in writing, each Advance shall be made by crediting the Member’s DID Account.

(b) The Member shall be estopped from asserting any claim or defense with respect to the terms applicable to an Advance or a Commitment for an Advance unless, within two (2) business days of receipt of the Bank’s Confirmation of Advance, the Member delivers to the Bank a written notice specifying the disputed term(s) or condition(s) of the Advance or Commitment for an Advance. Upon the request of the Bank, the Member shall sign and deliver to the Bank a promissory note or notes in such form as the Bank may reasonably require evidencing any Advance.

Section 2.02 REPAYMENT OF ADVANCES.

(a) The Member agrees to repay the principal amount of each Advance in accordance with this Agreement and the terms and conditions specified in the Application, the Confirmation of Advance and any other document evidencing such Advance which document is executed by both the Member and the Bank, or, in the case of an open line of credit Advance, on demand. Interest shall be paid on each Advance at the times specified by the Bank in the Credit Policy, the Application, the Confirmation of Advance and any other documents evidencing such Advance and shall be charged for each day that an Advance is outstanding at the rate applicable to each such Advance.

(b) The Member shall ensure that, on any day on which any payment is due to the Bank with respect to an Advance or other Indebtedness, the DID Account has an available balance in an amount at least equal to the amounts then currently due and payable to the Bank, and the Member hereby authorizes the Bank to debit the DID Account for any and all such amounts. In the event that the available balance in the DID Account is insufficient to pay such due and payable amounts, the Bank may, without notice to or request from the Member, apply any other deposits, credits, or monies of the Member then in the possession or control of the Bank (exclusive of any such items as are held by the Bank as bailee for a third party) to the payment of amounts due and payable or, in the sole discretion of the Bank, the Bank may fund an Advance to the Member in the amount of the insufficiency, which Advance shall bear interest from the date the same shall be made until paid at the rate in effect and being charged by the Bank from time to time on overdrafts on daily investment deposit accounts of its members.

(c) The Member shall pay to the Bank, immediately and without demand, interest on any past due amount owing on any outstanding Advance (other than an Advance made pursuant to Section 2.02(b)) or other Indebtedness at the interest rate set forth in the Credit Policy.

(d) All payments with respect to Advances shall be applied first to any fees or charges applicable thereto and to interest due thereon, in such order as the Bank may determine, and then to any principal amount thereof.

Section 2.03 ADVANCES RELATED TO THIRD PARTY COMMITMENTS.

(a) (1) If an Event of Default has occurred and is continuing, the Bank may at its option, and without notice to or request from the Member, or

(2) If the Bank reasonably and in good faith, determines that a material adverse change of the Member’s financial condition has occurred or the Bank believes, in good faith, that the prospect of payment or performance of any obligations or any performance under this Agreement is materially impaired, the Bank may at its option, and upon reasonable prior written notice to the Member,

make an Advance by crediting a special account of the Member with the Bank, such special account to be established by the Bank at such time, in an amount equal to the aggregate amount of any and all Outstanding Commitments that the Bank has issued on the Member’s behalf to or for the benefit of parties other than the Member. The Bank shall have a first priority perfected security interest in any such special account, and amounts credited to such special account may not be withdrawn by the Member for so long as there shall be Outstanding Commitments. Amounts credited to such special account shall be utilized by the Bank for the purpose of satisfying the Bank’s obligations under such third party Commitments. When all such obligations have expired or have been satisfied, the Bank shall disburse the balance, if any, in such special account first to the satisfaction of any amounts then due and owing by the Member to the Bank and then to the Member or its successors in interest. Advances made pursuant to this Section 2.03 shall be payable on demand and shall bear interest from the date made until paid at the rate in effect and being charged by the Bank from time to time on overdrafts on daily investment deposit accounts of its members.

(b) The Bank shall not be obligated to honor an Outstanding Commitment to the Member (excluding any Outstanding Commitments issued on behalf of the Member for the benefit of third parties) if the Member’s access to advances is restricted pursuant to § 1266.4 of the Federal Housing Finance Agency Regulations (or any successor to such provision), an Event of Default has occurred under this Agreement or if after giving effect to the related Advance, the Member would not be in compliance with its Collateral Maintenance Level. The Member releases the Bank from any and all liability in connection with such action by the Bank.

Section 2.04 AMORTIZATION OF ADVANCES.

(a) If the Bank determines, in its sole discretion, that the creditworthiness of the Member does not meet the minimum requirements of the Bank, the Bank may, or

(b) If the Bank reasonably and in good faith believes that the prospect of payment or performance of any obligations or any performance under this Agreement is materially impaired, the Bank may at its option, and upon five (5) business days written notice to the Member,

require amortization by means of monthly payments of principal on all or part of the Member's Advances, specifying the amortization period. The Member agrees to begin making such monthly amortization payments upon receipt of written notice from the Bank, in such amounts as the Bank shall specify in writing, calculated over such amortization period. The Member shall make such payments while any amount remains unpaid on the subject Advances or until notified otherwise by the Bank. No monthly payment shall exceed ten percent (10%) of the original principal balance of the Advance being amortized. Unless otherwise specified by the Bank in writing to the Member, such monthly amortization payments shall not extend the maturity date or other scheduled payment dates applicable to the Advance being amortized. Amortization payments required pursuant to this Section 2.04 shall be in addition to all other required payments of principal and interest with respect to Advances.

Section 2.05 DISCRETION OF THE BANK TO GRANT OR DENY ADVANCES. Nothing contained herein, in the Credit Policy, or in any other documents describing or setting forth the Bank's credit program and credit policies shall be construed as an agreement or Commitment on the part of the Bank to grant Advances or extend Commitments for Advances hereunder or to enter into any other transaction, the right and power of the Bank, in its discretion to either grant or deny any Application or other request for an Advance or Commitment for an Advance in its sole discretion being expressly reserved. The determination by the Bank of the Collateral Value of a Member's Qualifying Collateral shall not constitute a determination by the Bank that the Member may obtain Advances or Commitments for Advances up to the maximum amount that could be supported by such Qualifying Collateral based on the Collateral Maintenance Level.

Section 2.06 ELECTRONIC TRANSACTIONS. The parties agree that the transactions encompassed under this Agreement may be conducted electronically through whatever means the Bank may provide from time to time. An Application submitted electronically must be transmitted in accordance with the procedures established by the Bank and communicated to the Member. The Bank may rely upon and enforce an Application submitted electronically to the same extent as if such Application were written and signed on paper and in ink.

Section 2.07 INTEREST RATE LIMITATION. Notwithstanding anything herein to the contrary, if at any time the interest rate applicable to any Indebtedness, together with all fees and other charges that are treated as interest on such Indebtedness under applicable law, shall exceed the maximum lawful rate (the "maximum rate") that may be contracted for, charged, taken, received or reserved by the Bank in accordance with applicable law, the rate of interest payable in respect of such Indebtedness, together with all of the charges payable in respect thereof, shall be limited to such maximum rate.

## ARTICLE III
## SECURITY AGREEMENT

Section 3.01 CREATION OF SECURITY INTEREST.

(a) As security for all Indebtedness and Outstanding Commitments, the Member hereby assigns, transfers, and pledges to the Bank, and grants to the Bank a first and prior security interest in:

(i) all of the following as may be now owned or existing or hereafter owned by the Member:

(A) Capital Stock;
(B) Deposit Accounts;

(ii) such First Mortgage Collateral, Other Real Estate Related Collateral, Securities and Additional Collateral that are delivered pursuant to Section 3.04 hereof; and
(iii) all payment intangibles related to, and all cash and non-cash proceeds of the foregoing.

Without limitation of the foregoing and for the avoidance of doubt, all property heretofore assigned, transferred, or pledged by the Member to the Bank or as to which the Member has granted a security interest to the Bank, as collateral for Advances or Commitments or other Indebtedness prior to the date hereof is Collateral hereunder.

(b) The Member shall make, execute, acknowledge, record, and deliver to the Bank such financing statements, notices, assignments, listings, powers, and other documents with respect to the Collateral and the Bank's security interest therein and in such form as the Bank may reasonably require. To the extent permitted by applicable law, the Member hereby irrevocably authorizes the Bank to file, in the name of the Member or otherwise and without the signature or other separate authorization or authentication of the Member appearing thereon, such UCC financing statements (including, without limitation, continuations and amendments) and in such jurisdictions as the Bank may deem necessary or appropriate to perfect or maintain the perfection of the security interest of the Bank with respect to any Collateral. The Member agrees that a photocopy, electronic or other reproduction of this Agreement or of a financing statement is sufficient as a financing statement. The Member shall pay the cost of, or incidental to, any recording or filing of any financing statements (including, without limitation, continuations and amendments) or other assignment documents concerning the Collateral.

Section 3.02 COLLATERAL MAINTENANCE LEVEL REQUIREMENT.

(a) The Member shall at all times maintain as Collateral an amount of Qualifying Collateral that has a Collateral Value that is at least equal to the then current required Collateral Maintenance Level. The Member shall not assign, pledge, transfer, create any security interest in, sell, or otherwise dispose of any Collateral without the prior written consent of the Bank except as may be specified in the Credit Policy.

(b) Any Collateral that has not been delivered in accordance with Section 3.04 hereof shall be held by the Member in trust for the benefit of, and subject to the direction and control of, the Bank and will be physically safeguarded by the Member with at least the same degree of care as the Member uses in physically safeguarding its other property. Without limitation of the foregoing, the Member shall take all action necessary or desirable to protect and preserve the Collateral and the Bank's interest therein, including without limitation causing the property owner or applicable servicer of any First Mortgage Collateral or Other Real Estate Related Collateral to maintain insurance on property securing First Mortgage Collateral or Other Real Estate Related Collateral (any and all policies and certificates of insurance or guaranty relating to such Mortgages are herein called "insurance"), the collection of payments under all Mortgages and under all insurance, and otherwise causing all Mortgages to be serviced in accordance with the standards of a reasonable and prudent servicer in the mortgage industry.

(c) If the Member becomes aware or has reason to believe that the Collateral Value of the Member's Qualifying Collateral has fallen below the Collateral Maintenance Level (such belief being based on information, including but not limited to, updated appraisals, revised model valuations and information obtained in connection with Member's evaluation of its loan loss reserves), or that a contingency exists which with the lapse of time would result in the Member failing to meet the Collateral Maintenance Level, the Member shall immediately notify the Bank. If any Collateral that was Qualifying Collateral delivered pursuant to Section 3.04 hereof ceases to be Qualifying Collateral, the Member shall promptly notify the Bank in writing of that fact and, if so requested by the Bank, the reason that the Collateral has ceased to be Qualifying Collateral. In such case, the Member shall promptly specify, or deliver, as the case may be, other Qualifying Collateral sufficient to maintain its Collateral Maintenance Level.

Section 3.03 [RESERVED].

Section 3.04 DELIVERY OF COLLATERAL.

(a) The Member shall deliver to the Bank, or to a custodian designated or approved by the Bank, Qualifying Collateral having a Collateral Value at least equal to the Collateral Maintenance Level at all times. Any Collateral that is delivered under this subsection as a part of the Qualifying Collateral must conform to the requirements set forth in the Credit Policy for such Collateral.

(b) The Member agrees to pay the Bank such reasonable fees and charges as may be assessed by the Bank to cover the overhead and other costs of the Bank relating to the receipt, holding, redelivery, and reassignment of Collateral, and to reimburse the Bank upon request for all recording fees and other reasonable expenses, disbursements, and advances incurred or made by the Bank in connection therewith, including reasonable compensation and the expenses and disbursements of any custodian that may be appointed by the Bank hereunder, and the agents and legal counsel of the Bank and such custodians.

Section 3.05 RELEASE OF COLLATERAL. Upon receipt of the Bank of writings or electronic submissions in the form specified by the Bank in the Credit Policy constituting: (a) a request from the Member for release of Collateral; (b) a detailed listing of the Collateral to be released; and (c) a certificate of a responsible officer of the Member certifying as to the Qualifying Collateral remaining after such withdrawal, and upon the Bank's determination that the Collateral Value of the remaining Qualifying Collateral is not less than the current required Collateral Maintenance Level, the Bank shall or shall cause the custodian to promptly redeliver, release, or reassign to the Member, as applicable, at the Member's expense, the Collateral specified in the Member's listing of the Collateral to be released. Notwithstanding anything to the contrary in this Section 3.05, (i) while an Event of Default shall have occurred and be continuing; or (ii) at any time that the Bank reasonably believes in good faith that the prospect of payment or performance of any obligations or any performance under this Agreement by the Member is materially impaired, or (iii) the Member would fail to satisfy its Collateral Maintenance Level, the Member may not obtain any such release of collateral.

Section 3.06 BANK'S RESPONSIBILITIES AS TO COLLATERAL. The duty of the Bank as to the Collateral shall be solely to use reasonable care in the custody and preservation of the Collateral in its possession, which shall not include (i) any steps necessary to preserve rights against parties with a prior position or (ii) the duty to send notices, perform services, or take any action in connection with the collection or management of the Collateral. The Bank shall not have any responsibility or liability for the form, sufficiency, correctness, genuineness, or legal effect of any instrument or document constituting a part of the Collateral, or any signature thereon or the description or misdescription, or value of property represented, or purported to be represented, by any such document or instrument. The Member agrees that any and all Collateral may be removed by the Bank from the state or location where situated, and may be subsequently dealt with by the Bank as provided in this Agreement.

Section 3.07 BANK'S RIGHTS AS TO COLLATERAL; POWER OF ATTORNEY.

(a) At any time, at the expense of the Member, the Bank may in its reasonable discretion, after the occurrence and during the continuation of an Event of Default, in its own name or in the name of its nominee or of the Member, take any and all reasonable actions that are pertinent to the protection of the Bank's interest hereunder and, if such actions are subject to the laws of a state, are lawful under the laws of the State of Illinois including, but not limited to the following:

(1) Terminate any consent given hereunder;

(2) Notify obligors on any Collateral to make payments thereon directly to the Bank or the Bank's nominee or servicer;

(3) Endorse any Collateral on behalf of the Member;

(4) Enter into any extension, compromise, settlement, release, renewal, exchange, or other agreement relating to or affecting any Collateral;

(5) Take any action the Member is required to take or which is otherwise reasonably necessary to (A) file a financing statement or otherwise perfect a security interest in any or all of the Collateral or (B) obtain, preserve, protect, enforce, or collect the Collateral;

(6) Take control of any funds or other proceeds generated by the Collateral and use the same to reduce Indebtedness as it becomes due (or hold the same as Additional Collateral); and

(7) Cause the Collateral to be transferred to its name or the name of its nominee.

(b) In connection with entering into this Agreement, the Member has executed a power of attorney substantially in the form of Exhibit A hereto. In exercising its rights under the power of attorney, the Bank is limited by the provisions of Section 3.07(a) and may only take reasonable actions that are pertinent to the protection of the Bank's interest under this Agreement. Further, the Bank shall only exercise its rights under such power of attorney if (i) it believes in good faith that the prospect of payment or performance of any obligations or any performance under this Agreement by the Member is materially impaired (and Bank shall provide five (5) business days prior notice to Member if it is exercising its rights under this Section 3.07(b)(i)); or (ii) an Event of Default under this Agreement shall have occurred and shall be continuing.

Section 3.08 SUBORDINATION OF OTHER LOANS TO COLLATERAL. The Member hereby agrees that all Mortgage Notes which are part of the Collateral (other than home equity loans and lines of credit) ("pledged notes") shall have priority in right and remedy over any other loans, advances, obligations or indebtedness of the Member or Affiliate, whenever made, and, however evidenced ("Subordinated Debt"), which are also secured by the mortgages securing the pledged notes and/or by liens on the same properties encumbered by the Mortgages securing the pledged notes. Subject to applicable state and federal law, the pledged notes shall be satisfied out of the property (or proceeds thereof) encumbered by such Mortgages before recourse to such property may be obtained for the repayment of any Subordinated Debt. To this end, the Member hereby subordinates (i) the Subordinated Debt to the pledged notes and (ii) the lien of any First Mortgage Collateral or Other Real Estate Related Collateral that secure the Subordinated Debt to the lien of the Mortgages and security agreements that secure the pledged notes. The Member further agrees to retain possession of all notes or other instruments evidencing any Subordinated Debt and not to pledge, assign, or transfer the same, or any interest therein, except insofar as such Subordinated Debt may be pledged to the Bank as part of the Collateral.

Section 3.09 PROCEEDS OF COLLATERAL. The Member, as the Bank's agent, shall collect all payments when due on all Collateral. Upon receipt of written notice from the Bank after the occurrence and during the continuance of an Event of Default, the Member shall hold such collections and other proceeds of Collateral separate from its other monies in one or more designated cash collateral accounts maintained at the Bank and apply them to the reduction of Indebtedness as it becomes due; otherwise, the Bank consents to the Member's use and disposition of all such collections, except as may otherwise be provided under a control agreement executed by the parties.

Section 3.10 COLLATERAL AUDITS; REPORTS AND ACCESS.

(a) All Collateral, the satisfaction of the Collateral Maintenance Level, and Member's compliance to Section 5.01A shall be subject to audit and verification by or on behalf of the Bank. Such audits and verifications may occur upon reasonable notice during the Member's normal business hours or at such other times as the Bank may reasonably request. The Member shall provide to the Bank such reports relating to the Collateral as may be called for pursuant to the Credit Policy or as the Bank may otherwise reasonably require. The Member shall provide the Bank access to the Member's books and records relating to such Collateral and shall make adequate working facilities available to the representatives or agents of the Bank for purposes of such audits and verification. Reasonable fees and charges may be assessed to the Member by the Bank to cover the Bank's costs relating to such audit and verification.

(b) Notwithstanding anything to the contrary, the Member shall be solely responsible for the accuracy and adequacy of all information and data in each audit or status report (or other writing specifying and describing any Collateral) submitted to the Bank, regardless of the form in which submitted. To enable the Bank to regenerate any files or data previously furnished to the Bank with respect to any Collateral or any information contained in any audit or status report, the Member shall at all times maintain complete and accurate records and materials supporting or relating to any audit or status report and shall make the same available, on request, to the Bank. The parties hereto agree that the maintenance and retention of such supporting records and materials shall be the sole responsibility of the Member and that the Bank shall not be liable for any loss of such data.

(c) The Bank shall have no duty to make any independent examination of or calculation with respect to the information submitted in an audit or status report (or in any written schedule that may be submitted by the Member) and, without limiting the generality of the foregoing, the Bank makes no representation or warranty as to the validity, accuracy, or completeness of any information contained in any written records of the Bank concerning, or of any response to, such audit or status report.

Section 3.11 MEMBER'S REPRESENTATIONS AND WARRANTIES CONCERNING COLLATERAL. The Member represents and warrants to the Bank, as of the date hereof and the date of each Advance hereunder, as follows:

(a) The Member owns and has marketable title to the Collateral and has the right and authority to grant a security interest in the Collateral and to subject all of the Collateral to this Agreement;

(b) The information given in any status report, schedule, or other documents required hereunder and any other information given from time to time by the Member as to each item of Collateral is, at the time made, true, accurate, and complete in all material respects;

(c) All the Collateral meets the standards and requirements with respect thereto from time to time established by the Act, the Regulations, and the Bank;

(d) Based on title insurance and attorney opinions, the lien of the First Mortgage Collateral and Other Real Estate Related Collateral on the real property securing the same is a perfected lien under applicable state law and the lien is a first lien except with respect to (1) home equity loans or lines of credit and (2) subordinate loans which are not reported by the Member as Qualifying Collateral;

(e) The Member has not conveyed or otherwise created, and there does not otherwise exist, any participation interest or other direct, indirect, legal, or beneficial interest in any Qualifying Collateral on the part of anyone other than the Bank and the Member;

(f) To the best of Member's knowledge, all Mortgage documents, securities and other instruments and documents constituting a part of the Collateral constitute valid and binding obligations of their respective issuers and obligors enforceable against such issuers and obligors in accordance with their respective terms, subject to the effect of bankruptcy, insolvency and other similar laws affecting the rights of creditors generally and to general principles of equity;

(g) Except as may be approved in writing by the Bank, to the best of Member's knowledge, no account debtor or other obligor owing any obligation to the Member with respect to any item of Qualifying Collateral has any defenses, offsetting claims, or other rights affecting the right of the Member or the Bank to enforce any Mortgage or Mortgage Note relating thereto, and no defaults (or conditions that, with the passage of time or the giving of notice or both, would constitute a default) exist under any such Mortgage or Mortgage Note;

(h) To the best of Member's knowledge, no part of any real property or interest in real property that is securing Mortgages included in Qualifying Collateral contains or is subject to the effects of toxic or hazardous materials or other hazardous substances (including those defined in the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended, 42 U.S.C. 9601, et seq.; the Hazardous Materials Transportation Act, 49 U.S.C. 1801 et seq.; the Resource Conservation and Recovery Act, 42 U.S.C. 6901 et seq.; and in the regulations adopted and publications promulgated pursuant to said laws) the presence of which could subject the Bank or its successors and assigns to any liability under applicable state or Federal law or local ordinance either at any time that such property is pledged to the Bank or upon the enforcement by the Bank of its security interest therein. The Member hereby agrees to indemnify and hold the Bank harmless against all costs, claims, expenses, damages, and liabilities resulting in any way from the presence or effects of any such toxic or hazardous substances or materials in, on, or under any real property or interest in real property that is subject to or included in the Collateral.

(i) Except as may be approved in writing by the Bank, Member and/or an Affiliate are the servicer of the First Mortgage Collateral and Other Real Estate Related Collateral.

(j) The exact legal name of the Member, the type and jurisdiction of organization of the Member, and the location of the Member's chief executive office, each as stated in the first paragraph of this Agreement is true, accurate, and complete. The Member will provide prior written notice to the Bank, as soon as reasonably practicable, of any change to its name, its type and jurisdiction of organization, or the location of its chief executive office.

## ARTICLE IV
## DEFAULT; REMEDIES

Section 4.01 EVENTS OF DEFAULT; ACCELERATION. Upon the occurrence of and during the continuation of any of the following events or conditions of default ("Event of Default"), the Bank may at its option and in its discretion, by a notice to the Member, declare all or any part(s) of the Indebtedness and accrued interest thereon, including any prepayment fees or charges which are payable in connection with the payment prior to the originally scheduled maturity of any Advance, to be immediately due and payable without presentment, demand, protest, or any further notice:

(a) Failure of the Member to pay when due any principal of any Advance or failure of the Member to pay within three (3) business days after the date when due any interest on any Advance;

(b) Material breach or failure of the Member to comply with the requirements of the Credit Policy or perform any covenant, promise, or obligation or to satisfy any condition or liability contained herein, in any Application, Confirmation of Advance or in any other agreement to which the Member and the Bank are parties, provided Member shall have five (5) business days to cure any such material breach or default that is not related to any collateral requirement as set forth in the Credit Policy or the documents identified in this subsection (b);

(c) In the Bank's good faith and reasonable determination, evidence coming to the attention of the Bank that any representation, statement, or warranty made or furnished in any manner to the Bank by or on behalf of the Member in connection with any Advance, any specification or description of Qualifying Collateral or any report or certification concerning the status, principal balance or Collateral Value of any item of Collateral was false in any material respect when made or furnished, provided however, if such condition is capable of being cured (i) by the substitution of Qualifying Collateral, then Member may immediately substitute Qualifying Collateral; or (ii) Member may immediately pay down Member's Indebtedness so that the amount of Qualifying Collateral has a Collateral Value that is at least equal to the then current required Collateral Maintenance Level in order to cure the condition.;

(d) Failure of the Member to maintain Qualifying Collateral free of any encumbrances or claims as required herein;

(e) The issuance of any material tax, levy, seizure, attachment, garnishment, levy of execution, or other process with respect to the Collateral; provided however, if such condition is capable of being cured (i) by the substitution of Qualifying Collateral, then Member may immediately substitute Qualifying Collateral; or (ii) Member may immediately pay down Member's Indebtedness so that the amount of Qualifying Collateral has a Collateral Value that is at least equal to the then current required Collateral Maintenance Level, in order to cure the condition;

(f) Any suspension of payment by the Member or an Affiliate to any creditor of material sums due, unless such amount is being disputed in good faith by the Member, or the occurrence of any event which results (or which with the giving of notice or passage of time, or both, will result) in another creditor having the right to accelerate the maturity of any indebtedness of the Member or an Affiliate under any security agreement, indenture, loan agreement, instrument, or comparable agreement or the early termination or close-out of any Swap Transaction or other derivatives contract (other than in the normal course of business);

(g) The Member or any Affiliate of the Member:

(1) becomes insolvent or is unable to pay its debts or fails or admits in writing its inability generally to pay its debts as they become due;

(2) makes a general assignment, arrangement or composition with or for the benefit of its creditors;

(3)(A) institutes or has instituted against it, by a regulator, supervisor or any similar official with primary insolvency, rehabilitative or regulatory jurisdiction over it, a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors' rights, or a petition is presented for its winding-up or liquidation by it or such regulator, supervisor or similar official, or

(B) has such a proceeding instituted against it by a person or entity not described in clause (3)(A) herein and such proceeding either results in a judgment of insolvency or bankruptcy or the entry of an order for relief or the making of an order for its winding-up or liquidation or is not appealed, dismissed, discharged, stayed or restrained within 45 days;

(4) commences winding-up, official management or liquidation (other than pursuant to a consolidation, amalgamation, merger or the orderly winding-up of a material subsidiary of an Affiliate of the Member in the ordinary course of the business of the Member or of any such Affiliate);

(5) seeks or becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets;

(6) has a secured party take possession of all or substantially all its assets or has a distress, execution, attachment, sequestration or other legal process levied, enforced or sued on or against all or substantially all its assets, or in the case of a suit which suit is not dismissed or unwound within 90 days after its commencement; or

(7) takes any action in furtherance of, or indicating its consent to, approval of, or acquiescence in, any of the foregoing acts;

(h) Sale by the Member of all or a material part of the Member's assets (other than in connection with a securitization transaction or other portfolio sale of mortgage loans or mortgage-backed securities) or the taking of any other action by the Member to liquidate or dissolve;

(i) Termination for any reason of the Member's membership in the Bank, or the Member's ceasing to be a type of entity that is eligible under the Act to become a member of the Bank, in each case, at such time as the Member has any outstanding Indebtedness due to the Bank;

(j) Merger, consolidation, or other combination of the Member with an entity which is not a member of the Bank if the nonmember entity is the surviving entity;

(k) The Bank reasonably and in good faith determines that a material adverse change has occurred in the financial condition of the Member or an Affiliate from that disclosed at the time of the making of any Advance or from the condition of the Member or an Affiliate as theretofore most recently disclosed to the Bank which could either (1) affect the ability of the Member to perform its obligations under this Agreement or (2) impair the prospect of repayment of any portion of the Indebtedness;

(l) Any Official Body takes any action with respect to the Member or an Affiliate which (i) is in anticipation of a takeover or assumption of control of the Member or an Affiliate by any Official Body; (ii) is a takeover or assumption of control of the Member or Affiliate by any Official Body; or (iii) results in the supervision of the Member's operations pursuant to an order of any court or Official Body or results in the supervision of Affiliate's operations pursuant to an order of any court of Official Body to the extent such supervision (a) would materially adversely affect the Member's ability to perform its obligations under this Agreement or (b) actually impairs the prospect of repayment of any portion of the Indebtedness by the Member; provided, however, supervision of the Member's or an Affiliate's operations by an Official Body shall encompass significant orders covering a material portion of such Member's or Affiliate's operations and shall not include immaterial regulatory actions or memoranda of understanding, written agreements and orders that relate to compliance matters such as reporting and commercial or consumer lending issues;

(m) [Reserved].

(n) With respect to the Member's RBC Level, the occurrence of a violation of (i) state insurance Law applicable to the Member, or (ii) the policies and procedures of the state insurance department or a federal regulatory body having regulator authority over the Member, whether or not having the force and effect of Law.

Section 4.02 REMEDIES.

(a) Upon the occurrence of any Event of Default, the Bank shall have all of the rights and remedies provided by applicable law which shall include, but not be limited to, all of the remedies of a secured party under the UCC.

(b) Without limiting or affecting other rights of the Bank pertaining to the Collateral contained herein or as may be otherwise provided under a control agreement executed by the parties, upon the occurrence of any Event of Default, the Bank, at its option and in its discretion, may take or cause its agent to take immediate possession or control of any of the Collateral or any part thereof wherever the same may be found by suit or otherwise. The Bank may sell, assign, and deliver the Collateral or any part thereof at public or private sale (at the sole option of the Bank), without recourse for such price as the Bank deems appropriate without any liability for any loss due to a decrease in the market value of the Collateral during the period held. The Bank shall have the right to purchase all or part of the Collateral at such sale free of any right of

redemption on the part of the Member which right is expressly waived and released to the fullest extent permitted by law. If the Collateral includes insurance or securities which will be redeemed by the issuer upon surrender, or any deposits or other accounts in the possession or control of the Bank, the Bank may realize upon such Collateral without notice to the Member.

(c) Upon the occurrence of any Event of Default, the Member waives any demand, advertisement, or notice of the time or place of intended disposition of any of the Collateral except to the extent required by applicable law. Any such notification shall be deemed reasonably and properly given if given as provided by applicable law or in accordance with Section 5.06 hereof at least 10 days before any such disposition. The Member agrees that the Bank may exercise its rights of setoff upon the occurrence of an Event of Default in the same manner as if the Advances and other Indebtedness were unsecured.

(d) Notwithstanding any other provision hereof, upon the occurrence of any Event of Default at any time when all or part of the obligations of the Member to the Bank hereunder shall be the subject of any guarantee by a third party for the Bank's benefit and there shall be other outstanding obligations of the Member to the Bank that are not so guaranteed but that are secured by the Collateral, then any sums realized by the Bank from the Collateral, or from any other collateral pledged or furnished to the Bank by the Member under any other agreement, shall be applied first to the satisfaction of such other nonguaranteed obligations and then to the Member's guaranteed obligations hereunder.

(e) The Member agrees to pay all the reasonable costs and expenses of the Bank in the collection of the Indebtedness and enforcement and preservation of the Bank's rights and remedies in case of default, including, without limitation, reasonable attorneys' fees. Any sums owed to the Bank under this Section 4.02(e) may be collected by the Bank, at its option, by debiting the Member's DID Account with the Bank.

Section 4.03 PAYMENT OF PREPAYMENT CHARGES. Any prepayment fees or charges applicable to an Advance shall be calculated in accordance with the formula set forth in the Bank's Credit Policy and shall be payable at the time of any voluntary or involuntary payment of all or part of the principal of such Advance prior to the originally scheduled maturity thereof, including without limitation payments that are made as part of a liquidation of the Member or that become due as a result of an acceleration pursuant to Section 4.01 hereof, whether such payment is made by the Member, by a conservator, receiver, liquidator, Affiliates or trustee of or for the Member, or by any successor to or any assignee of the Member.

Section 4.04 CERTAIN PROVISIONS AS TO SALE OF COLLATERAL. In view of the possibility that Federal and state securities laws and Federal and state laws applicable to the Member may impose certain restrictions on the method by which a sale of the Collateral may be effected, the Bank and the Member agree that any sale of the Collateral as a result of an Event of Default shall be deemed "commercially reasonable" irrespective of whether the notice or manner of such sale contains provisions, or imposes, or is subject to, conditions or restrictions deemed appropriate to comply with the Securities Act of 1933 or any other applicable Federal or state securities law or any state or Federal law applicable to the Member. It is further agreed that from time to time the Bank may attempt to sell the Collateral by means of private placement. In so doing, the Bank may restrict the bidders and prospective purchasers to those who will represent and agree that they are purchasing for investment only and not for distribution or otherwise impose restrictions deemed appropriate by the Bank for the purpose of complying with the requirements of applicable securities laws. The Bank may solicit offers to buy such Collateral, for cash or otherwise, from a limited number of investors deemed by the Bank to be responsible parties who might be interested in purchasing such Collateral. If the Bank solicits offers from not less than three such investors, then the acceptance by the Bank of the highest offer obtained therefrom (whether or not three offers are obtained) shall be deemed to be a commercially reasonable method of disposing of the Collateral.

Section 4.05 APPLICATION OF PAYMENTS. Upon the occurrence of any Event of Default, the Bank shall apply any payment by or recovery from the Member, or any sum realized from Collateral which shall be received by the Bank (a) to payment of all costs of collection and enforcement; (b) to payment of the Indebtedness in such manner as the Bank shall choose; and (c) to offset any amounts to be paid or advanced under Outstanding Commitments. The Bank shall, unless otherwise required by applicable law, remit any surplus to the Member.

## ARTICLE V
## MISCELLANEOUS

Section 5.01 GENERAL REPRESENTATIONS AND WARRANTIES BY THE MEMBER; COVENANTS. The Member hereby represents, warrants, and covenants that, as of the date hereof and the date of each Advance hereunder, and so long as any Indebtedness remains unpaid:

(a) The Member is not, and neither the execution of nor the performance of any of the transactions or obligations of the Member under this Agreement shall, with the passage of time, the giving of notice or otherwise, cause the Member to be: (1) in violation of its charter or articles of incorporation, bylaws, the Act or the Regulations, any other law or administrative regulation, including, but not limited to, any applicable anti-predatory lending law or regulation, any court decree, or any order of an Official Body; provided however, Member's representation that it is not in violation of any administrative regulation refers to regulatory violations that could have a material impact on the financial condition of the Member and does not include immaterial regulatory violations that may be raised as part of a regulatory examination such as reporting and commercial or consumer lending compliance matters; or (2) in default under or in breach of any indenture, contract, or other instrument or agreement to which the Member is a party or by which it or any of its property is bound which would have a material adverse effect on Member;

(b) The Member has full corporate power and authority and has received all corporate and governmental authorizations and approvals (including without limitation those required under the Act and the Regulations) as may be required to enter into and perform its obligations under this Agreement, to borrow each Advance, and to obtain each Commitment for an Advance;

(c) The information given by the Member in any document provided, or in any oral statement made, in connection with an Application, request for an Advance, Commitment for an Advance, a pledge, specification, or delivery of Collateral, is, at the time made, be true, accurate, and complete in all material respects;

(d) The Member, unless otherwise exempted, is in compliance with any Regulations pertaining to community investment or service adopted pursuant to Section 10(g) of the Act (12 U.S.C. 1430(g), as amended);

(e) All long-term Advances shall be utilized solely for the purpose of providing funds for residential housing finance. "Long-term" is defined as greater than five years in term or as defined by the Federal Housing Finance Agency;

(f) The Member shall notify the Bank immediately if it becomes aware of a material adverse event affecting the Member or its business or operations, including an event, which with a lapse of time, could cause the Collateral Value of Qualifying Collateral to fall below the Collateral Maintenance Level;

(g) The Member and the Bank each consents to the recording of telephone conversations in connection with this Agreement and any Advances and any other products and services that the Member may receive from time to time from the Bank;

(h) The Member's board of directors approved the execution of this Agreement and such approval is recorded in its official minutes and this Agreement has been, continuously, from the time of its execution, an official record of the Member;

(i) The Member shall deliver to the Bank, simultaneously with the Member's delivery thereof to the appropriate federal or state Official Body, a copy of each Form 10-K, 10-Q or other filing with the Securities and Exchange Commission, if any, with respect to Member and a copy of all financial statements, including without limitation all actuarial certifications required in accordance with applicable Law to be filed with any Official Body, such financial statements to be prepared in accordance with all of the requirements of applicable Law (without limitation, as to format, accounting methods and otherwise) or, in the event that there are no such requirements of applicable Law, then to be prepared in accordance with generally accepted accounting principles;

(j) If prepared by the Member, the Member shall provide to the Bank, as soon as available and in any event within forty-five (45) calendar days after the end of each of the first three (3) fiscal quarters in each fiscal year, and sixty (60) days after the end of each fiscal year, a detailed calculation of Member's estimated Risk-Based Capital and consolidated and consolidating financial statements of the Member, consisting of a balance sheet as of the end of such fiscal quarter and related statements of income, stockholders' equity and cash flows for the fiscal quarter then ended and the fiscal year through that

date, all in reasonable detail and certified (subject to normal year-end audit adjustments) by the Chief Executive Officer, President or Chief Financial Officer of the Member as having been prepared in accordance with, and in a form required by, applicable law and regulations of the applicable insurance regulatory authority, consistently applied, and setting forth in comparative form the respective financial statements for the corresponding date and period in the previous fiscal year;

(k) If prepared by the Member, the Member shall provide to the Bank, as soon as available in any event within one hundred twenty (120) days after the end of each fiscal year of the Member, consolidated and consolidating financial statements of the Member, which are provided to the applicable insurance regulatory authority, consisting of a balance sheet as of the end of such fiscal year, and related statements of income, stockholders' equity and cash flows for the fiscal year then ended, all in reasonable detail and setting forth in comparative form the financial statements as of the end of and for the preceding fiscal year, and certified by independent certified public accountants reasonably satisfactory to the Bank. The certificate or report of accountants shall be free of qualifications (other than any consistency qualification that may result from a change in the method used to prepare the financial statements as to which such accountants concur) and shall not indicate the occurrence or existence of any event, condition or contingency which would materially impair the prospect of payment or performance of any covenant, agreement or duty of the Member under this Agreement or the related documents evidencing or in connection with the Indebtedness;

(l) Concurrently with the financial statements of the Member furnished to the Bank pursuant to Sections 5.01(i), (j) and (k) hereof, a certificate of the Member signed by the Chief Executive Officer, President or Chief Financial Officer of the Member, to the effect that, (i) the representations and warranties of the Member contained in this Agreement and the related documents evidencing or in connection with the Indebtedness are true in all material respects on and as of the date of such certificate with the same effect as though such representations and warranties had been made on and as of such date and the Member has performed and complied in all material respects with all covenants and conditions hereof, and (ii) no Event of Default or event which with the passing of time or the giving of notice or both would become an Event of Default exists and is continuing on the date of such certificate;

(m) The Member shall automatically deliver to the Bank, without any request therefore by the Bank, a copy of each RBC Report of the Member, if any, and, if any, each RBC Plan of the Member, in each case, as filed in accordance with (i) the state insurance law applicable to Member or (ii) the policies and procedures of the state insurance department having regulatory authority over the Member, whether or not having the force and effect of Law;

(n) The Member shall deliver to the Bank within five (5) days of the occurrence thereof, a copy of any amendment to the Member's by-laws, articles or certificate of incorporation or other charter documents;

(o) The Member shall deliver to the Bank as soon as reasonably practicable such other information as the Bank's Credit Policy may from time to time require the Member to deliver to the Bank or as the Bank may otherwise from time to time reasonably request;

(p) The Member shall provide written notice to the Bank upon the occurrence of an Event of Default;

(q) Upon request from the Bank, the Member shall deliver to the Bank, in form and substance satisfactory to the Bank, an opinion of legal counsel of the Member, such legal counsel to be satisfactory to the Bank and such opinion to be as to those matters which the Bank may request, in its sole discretion, including without limitation: (i) confirming the power and authority of the Member to enter into this Agreement and the other related loan documents with respect to the Indebtedness and to consummate the transactions contemplated hereby and thereby; (ii) confirming the due authorization and execution of this Agreement and the other documents in connection with the Indebtedness to consummate the transactions contemplated thereby; and (iii) confirming the creation and perfection of the security interest of the Bank in the Collateral;

(r) The Member shall at all times comply with all applicable Law, including, without limitation, all Laws relating to: (i) the purchase or holding by the Member of those investments permitted by Law; (ii) transactions with affiliates; (iii) payment of dividends; and (iv) contributions to the Member's surplus except, in each case, where the failure to comply could not reasonably be expected to have a material adverse impact on the Collateral and/or the Bank's rights under this Agreement;

(s) The Member shall notify the Bank of any change in law generally applicable to insurance companies the result of which may have a material adverse impact upon the Member;

(t) The Member has no material litigation pending against the Member that materially adversely affect the Member's ability to perform its obligations under this Agreement and there is no regulatory order which has been issued by any Official Body that prohibits the Member from entering into this Agreement and the other related loan documents in respect of the Indebtedness and consummating the transactions contemplated hereby and thereby; and

(u) The Member shall not amend its by-laws, articles or certificate of incorporation or other charter documents in such a way that materially adversely impacts the Bank or its rights and remedies arising out of this Agreement.

Section 5.01A FINANCIAL COVENANTS.

(a) The Member covenants and agrees that as of the date hereof and the date of each Advance hereunder, and so long as any Indebtedness remains unpaid, that:

(i) the ratio of the sum of Member's total liabilities, but excluding debt subordinated to the Bank and any non-recourse debt, to Capital, as such amounts are reflected on Member's most recent unaudited quarterly financial statements or audited annual financial statements, as applicable, in each case prepared in accordance with generally accepted accounting principles ("GAAP"), is equal to or less than 9.00:1.00.

For purposes of this Section 5.01A(a)(i), Capital is defined to include stockholders equity and debt subordinated to the Bank.

(ii) Member shall at all times maintain unencumbered (A) Eligible Collateral (other than Capital Stock), (B) cash not included in Collateral Maintenance Level, and (C) cash held in the DID Account not included in Collateral Maintenance Level, with an aggregate Collateral Value that is greater than or equal to 25% of the difference between (y) Collateral Maintenance Level and (z) Indebtedness.

(b) Member shall deliver to the Bank, within seven (7) calendar days after the last day of each calendar quarter a certification signed by an authorized signer stating whether it has been in compliance throughout the quarter and whether it remains in compliance with the covenants set forth in Section 5.01 and the financial covenants set forth in Section 5.01A of this Agreement. Notwithstanding the quarterly certification requirement set forth in this Section 5.01A(b), Member shall notify Bank promptly at any time intra-quarter if Member is not in compliance with the covenants set forth in Sections 5.01 or 5.01A of this Agreement.

(c) Member shall deliver to Bank monthly, along with its listing file, a schedule identifying the assets that demonstrate Member's compliance with Section 5.01A(a)(ii).

Section 5.02 CHANGES TO CREDIT POLICY. The Bank reserves the right to amend, supplement, restate or otherwise modify the Credit Policy, including but not limited to, changes in underwriting criteria, collateral eligibility, reporting requirements, and collateral margins (each, a "Policy Modification") at any time, in its sole discretion, without the consent of the Member, and the Member (i) acknowledges and agrees that each such Policy Modification shall apply to all Advances and other Indebtedness (whether outstanding on the date of such Policy Modification or incurred after the date thereof) and (ii) agrees to be bound by each and every Policy Modification occurring on, prior to, or after the date of this Agreement. Each Policy Modification shall become effective immediately upon adoption by the Bank; provided, however, no Event of Default shall occur as a result of any Policy Modification until 45 days after the effective date of such Policy Modification. The Bank shall provide notice of any Policy Modification in writing, which may include by electronic mail, to the Member no later than 30 days after to the effective date of such Policy Modification; provided, however, such notice shall be deemed effective when given by the Bank. Notwithstanding the provisions of this Section, the Bank shall not amend, supplement, restate or otherwise modify the terms and conditions of any Advance specified in an Application or Confirmation of Advance without the consent of the Member.

Section 5.03 ASSIGNMENT. The Member hereby gives the Bank the full right, power, and authority to assign or transfer all or any part of the Bank's right, title, and interest in and to this Agreement, and to pledge, assign, or negotiate to any other Federal Home Loan Bank or to any other person or entity, with or without recourse, all or any part of the Indebtedness or participations therein; provided however, if the Bank assigns or transfers its interest in this Agreement or any Indebtedness to a third party other than another Federal Home Loan Bank or Federal Reserve Bank, the Bank will obtain the prior written consent of the Member. Assignment or transfer of this Agreement by the Bank to another Federal Home Loan Bank shall not be deemed to be an Event of Default under Section 4.01(i). In connection therewith, the Bank may assign and deliver the whole or any part of the Collateral to the transferee, which shall succeed to all the powers and rights of the Bank in respect thereof, and the Bank shall thereafter be forever relieved and fully discharged from any liability or responsibility with respect to the Collateral so assigned or pledged, and all references herein to the Bank shall be read to refer to the pledgee or assignee. The Member may not assign or transfer any of its rights or obligations hereunder without the express prior written consent of the Bank, which shall not be unreasonably withheld.

Section 5.04 AMENDMENT; WAIVERS. No modification, amendment, or waiver of any provision of this Agreement or consent to any departure therefrom shall be effective unless in a writing executed by an authorized officer of the party against whom such change is asserted and shall be effective only in the specific instance and for the purpose of which given. The terms of this Agreement may not be modified or amended unless both parties execute a written agreement. No notice to or demand on the Member in any case shall entitle the Member to any other or further notice or demand in the same, or similar or other circumstances. Any forbearance, failure, or delay by the Bank in exercising any right, power, or remedy hereunder shall not be deemed to be a waiver thereof, and any single or partial exercise by the Bank of any right, power, or remedy hereunder shall not preclude the further exercise thereof. Every right, power, and remedy of the Bank shall continue in full force and effect until specifically waived by the Bank in writing and no such waiver shall extend to any subsequent matter or impair any right consequent thereon except to the extent expressly so waived.

Section 5.05 JURISDICTION; LEGAL FEES. In any action or proceeding brought by the Bank or the Member in order to enforce any right or remedy under this Agreement, the parties hereby consent to, and agree that they will submit to, the exclusive jurisdiction of the United States District Court for the Northern District of Illinois or, if such action or proceeding may not be brought in Federal court, the jurisdiction of the courts of the State of Illinois located in the City of Chicago. The Member hereby waives, to the fullest extent permitted by law, any objection that it may now or hereafter have to the laying of venue in any such action or proceeding in such courts and any defense or objection based upon any such court being an inconvenient forum for purposes of any such action or proceeding. The parties agree that if any action or proceeding is brought by either party seeking to obtain any legal or equitable relief against the other party under or arising out of this Agreement or any transaction contemplated hereby and such relief is not granted by the final decision, after any and all appeals, of a court of competent jurisdiction, the losing party will pay all reasonable attorneys' fees and other costs incurred by the prevailing party in connection therewith. Each party agrees to reimburse the other party for all reasonable costs and expenses (including reasonable fees and out-of-pocket expenses of outside counsel) incurred by the former party in connection with the enforcement or preservation of the Bank's rights under this Agreement, including, but not limited to, its rights in respect of any Collateral and the audit or possession thereof. Any sums owed to the Bank under this Section 5.05 may be collected by the Bank, at its option, by debiting the Member's DID Account with the Bank.

Section 5.06 NOTICES. Any notice, advice, request, consent, or direction given, made, or withdrawn pursuant to this Agreement shall be given in writing or by an electronic transmission in such form and provided in accordance with such security procedures or similar protocols as may be established by the Bank, and must be delivered by: (a) hand delivery; (b) certified mail, return receipt requested; (c) internationally recognized overnight courier service, or (d) electronically, to the other party's respective address given below:

| | |
|---|---|
| If to Member: | RWT Financial, LLC<br>155 North Wacker Drive, Suite 4250<br>Chicago, Illinois 60606<br>Attention: Secretary<br>email: notices@redwoodtrust.com |
| and to: | RWT Financial, LLC<br>155 North Wacker Drive, Suite 4250<br>Chicago, Illinois 60606<br>Attention: Treasurer<br>email: notices@redwoodtrust.com |
| With a copy to: | Kaye Scholer LLP<br>3 First National Plaza<br>70 West Madison Street, Suite 4200<br>Chicago, Illinois 60602<br>Attention: Daniel J. Hartnett<br>email: daniel.hartnett@kayescholer.com |

and, in the case of a notice of an Event of Default, with a copy to:

Cenlar FSB
425 Phillips Blvd.
Ewing, New Jersey 08618
Attention: Legal Department
email: mfahywoehr@Cenlar.com

If to Bank: Federal Home Loan Bank of Chicago
200 E. Randolph Drive, 18th Floor
Chicago, Illinois 60601
Attention: Member Product Support
Email: membernotices@fhlbc.com

All notices, except for electronic notices, shall be deemed to have been delivered when the notice is either refused to be accepted or is received by the party to whom the notice is directed. Notices sent electronically shall be deemed delivered on the same business day on which it is sent electronically (or on the next business day, if such notification is sent out after 5:00 p.m. recipient's time).

Section 5.07 SIGNATURES OF MEMBER. For purposes of this Agreement, documents and electronic records shall be deemed signed by the Member when a signature or an electronic signature of the Member or an authorized signatory or an authorized facsimile thereof appears on or is associated with the document or electronic record. The Bank may rely on any signature or facsimile thereof which reasonably appears to the Bank to be the signature of an authorized person, including signatures appearing on documents transmitted electronically to and reproduced mechanically at the Bank. The secretary or an assistant secretary of the Member shall from time to time furnish to the Bank, on forms provided by the Bank, a certified copy of the resolution of the Board of Directors of the Member authorizing persons to apply on behalf of the Member to the Bank for Advances and Commitments and otherwise act for and on behalf of the Member in accordance with this Agreement together with specimen signatures or specimen electronic signatures of such persons. Such certifications are incorporated herein and made a part of this Agreement and shall continue in effect until expressly revoked in writing by the Member notwithstanding that subsequent certifications may authorize additional persons to act for and on behalf of the Member.

Section 5.08 APPLICABLE LAW; SEVERABILITY. In addition to the terms and conditions specifically set forth herein and in any Application or Confirmation of an Advance between the Bank and the Member, this Agreement and all Advances and all Commitments for Advances shall be governed by the statutory and common law of the United States and, to the extent Federal law incorporates or defers to state law, the laws (exclusive of the choice of law provisions) of the State of Illinois. Notwithstanding the foregoing, the Uniform Commercial Code as in effect in the State of Illinois shall be deemed applicable to this Agreement and to any Advance hereunder and shall govern the attachment and perfection of any security interest granted hereunder to the extent that the Act, Regulations, or other statutory law of the United States is not applicable. In the event that any portion of this Agreement conflicts with applicable law, such conflict shall not affect other provisions of this Agreement which can be given effect without the conflicting provision, and to this end the provisions of this Agreement are declared to be severable.

Section 5.09 SUCCESSORS AND ASSIGNS. This Agreement shall be binding upon and inure to the benefit of the successors and permitted assigns of the Member and Bank.

Section 5.10 ENTIRE AGREEMENT. This Agreement embodies the entire agreement and understanding between the parties hereto relating to the subject matter hereof and, except as specified in the next sentence, supersedes all prior agreements between such parties which relate to such subject matter. To the extent the Member and the Bank have entered into an Advances, Collateral Pledge and Security Agreement prior to the date hereof (the "Existing Agreement"): (a) any Advances and Commitments made by the Bank to the Member under the Existing Agreement shall continue to be governed by the terms of the Application or Confirmation of Advance pursuant to which such Advances and Commitments were made, and otherwise by the terms and conditions of this Agreement and (b) this Agreement shall not supersede or terminate any assignment or transfer of, pledge to or grant of a security interest in property made by the Member under the Existing Agreement to secure Advances or other Indebtedness by the Bank.

Section 5.11 CAPTIONS AND HEADINGS. The captions and headings in this Agreement are for convenience only and shall not be considered as part of or affect the construction or interpretation of any provision of this Agreement.

Section 5.12 SURVIVAL OF REPRESENTATIONS, WARRANTIES, AND COVENANTS. All representations, warranties, and covenants by the Member contained in this Agreement or made in writing in connection herewith, shall be continuing and shall survive execution and delivery of this Agreement and the incurrence of any Indebtedness.

IN WITNESS WHEREOF, the Member and the Bank have caused this Agreement to be signed in their names by their duly authorized officers as of the date first above mentioned.

MEMBER:

RWT FINANCIAL, LLC

By: /s/ Christopher J. Abate

Name: Christopher J. Abate
Title: Chief Financial Officer

Member Number: 03024-7

FEDERAL HOME LOAN BANK OF CHICAGO

By: /s/ Michelle Jonson

Name: Michelle Jonson
Title: Senior Vice President

By: /s/ Agnes Hardison

Name: Agnes Hardison
Title: Senior Vice President

**EXHIBIT A**

# IRREVOCABLE LIMITED POWER OF ATTORNEY

**KNOW ALL PERSONS BY THESE PRESENTS THAT** , RWT Financial, LLC (the "Member"), hereby irrevocably constitutes and appoints the Federal Home Loan Bank of Chicago (the "Bank") its true and lawful attorney-in-fact and agent with full power and authority, to prepare, execute, acknowledge, verify, swear to, deliver, endorse, assign, record and file and take every other necessary action with respect to, in its name, place and stead, all of the following:

a. Any and all promissory notes or any item of collateral (collectively, the "Notes") pledged by the Member to the Bank pursuant to the terms of the Advances, Collateral Pledge, and Security Agreement ("Advances Agreement"), dated as of _______________, 2014, between the Member and the Bank;

b. Any and all amendments, assignments, and/or releases of any mortgage, deed of trust, or deed to secure debt, or other security instrument, securing any of the Notes pledge by the Member to the Bank pursuant to the terms of the Advances Agreement; and

c. All such other documents as the Bank may deem necessary to (i) maintain and protect its security interest in any real and personal property, tangible or intangible, securing the Notes; or (ii) otherwise satisfy the Member's obligations under the Advances Agreement with respect to the Notes or any security instruments or agreements executed to secure the Notes.

Further, the Member hereby gives and grants to the Bank the authority to do or perform every lawful act necessary or proper in connection with the Notes as fully as the Member might or could do, and without limiting the foregoing, also authorizes the Bank to endorse the Notes using the following form of endorsement which may be hand written, stamped or imprinted, and Member hereby adopts the following as its signature for the purpose of authorizing the Bank to endorse the Notes:

PAY TO THE ORDER OF
WITHOUT RECOURSE

_______________________________________________

BY FEDERAL HOME LOAN BANK OF CHICAGO,
ITS ATTORNEY-IN-FACT

It is expressly understood and intended by the Member that the Power of Attorney hereby granted is coupled with an interest, is granted for a period commencing on the date of the incurrence of any Indebtedness (as defined in the Advances Agreement) and continuing until the discharge of all Indebtedness and all other obligations of the Member under the Advances Agreement regardless of any event of default thereunder, and is irrevocable for the period granted. This Power of Attorney shall survive the dissolution, liquidation, termination, or transfer of the interests of the Member.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this ___ day of ________, 20__.

RWT FINANCIAL, LLC

By: ________________________________________
Name: ________________________________________
Title: ________________________________________

SWORN AND WITNESSED in the presence of:

______________________________________________

**Acknowledgment**
(Illinois)

STATE OF ILLINOIS,
_____________ County ss:

The foregoing instrument was acknowledged before me this day __ of _____________, 20__ by ________________________________, ______________________________ of RWT Financial, LLC, a
[name of signer] [title of signer] [name of member]

special purpose captive insurance company under the laws of the State of Delaware, on behalf of RWT Financial, LLC.
[bank/corporation/association]

My Commission Expires: ____________________________________
Notary Public

This instrument was drafted by:
Federal Home Loan Bank of Chicago

**Exhibit 10.9**

SUPPLEMENT TO ADVANCES, COLLATERAL PLEDGE
AND SECURITY AGREEMENT—FINANCIAL COVENANTS

THIS SUPPLEMENT TO ADVANCES, COLLATERAL PLEDGE AND SECURITY AGREEMENT—FINANCIAL COVENANTS ("Financial Covenants Supplement"), dated as of July 16, 2014 between the FEDERAL HOME LOAN BANK OF CHICAGO, with its principal office located at 200 East Randolph Drive, Chicago, Illinois 60601 ("Bank"), RWT FINANCIAL, LLC, a Delaware limited liability company authorized by the Delaware Insurance Commissioner as a special purpose captive insurance company pursuant to a Certificate of Authority dated April 24, 2014 ("Member") organized under the laws of Delaware and having its chief executive office at 155 South Wacker Drive, Suite 4250, Chicago, Illinois 60606, and REDWOOD TRUST, INC., a corporation ("Company") organized under the laws of Maryland, and having its chief executive office at One Belvedere Place, Suite 300, Mill Valley, California 94941.

WHEREAS, Company is the parent company of Member; and

WHEREAS, Member and Bank have entered into an Advances, Collateral Pledge, and Security Agreement, dated July 16, 2014, ("Agreement"), which remains in full force and effect; and

WHEREAS, Company has guaranteed payment of all of Member's present and future obligations and liabilities of any kind to Bank pursuant to the Guaranty, dated July 16, 2014; and

WHEREAS, Company acknowledges that it will benefit from Bank entering into transactions with Member pursuant to the Agreement;

WHEREAS, Company and Member acknowledge that Company's financial condition will be considered by the Bank when entering into any transactions with Member.

NOW THEREFORE, Company, Member and Bank agree as follows:

Section 1.01. DEFINITIONS. Unless otherwise defined herein, terms defined in the Agreement will have such defined meanings when used herein. Terms defined herein will have such meanings for purposes of this Financial Covenants Supplement. To the extent a term, as defined in this Financial Covenants Supplement, is used in the Agreement, the definition in the Financial Covenants Supplement will control as regards the Company.

(a) "Cash Equivalent" means cash, U.S. Treasury Securities, debt or mortgage-backed securities (including participation certificates) issued by Federal Home Loan Mortgage Corporation or Federal National Mortgage Association, obligations guaranteed by Government National Mortgage Association, consolidated obligations of the Federal Home Loan Bank System and/or obligations issued or guaranteed by the United States or an agency thereof, any money market fund rated "AAA" or a comparable rating by a NRSRO, and any other securities as may be specified from time to time in the Credit Policy.

Section 2.01 FINANCIAL COVENANTS.

(a) Company covenants and agrees that at any time Member has any Indebtedness that remains unpaid, that:

(i) The ratio of the sum of Company's total liabilities, but excluding non-recourse debt, to the stockholders' equity, as such amounts are reflected on Company's most recent unaudited quarterly financial statements or audited annual financial statements, as applicable, in each case prepared in accordance with generally accepted accounting principles ("GAAP"), is equal to or less than 5.00:1.00.

(ii) Company has unencumbered Cash Equivalents in an amount of not less than $20,000,000.

(iii) Company has not been granted, nor has requested, a waiver of default from any creditor due to Company's suspension of payment to any creditor of material sums due or the occurrence of any event which results (or which the giving of notice or passage of time, or both, will result) in another creditor having the right to accelerate the maturity of any indebtedness of Company under any security agreement, indenture, loan agreement, instrument.

(b) (i) Company shall deliver to the Bank, in form and substance substantially similar to Schedule A attached hereto, within seven (7) calendar days after the last day of each quarter a certification signed by an authorized signer stating whether Company has been in compliance throughout the applicable quarter, whether Company remains in compliance with the financial covenants set forth in Section 2.01(a)(i) and (ii) of this Financial Covenants Supplement and whether there had been any material changes to any financial covenants similar to the types of financial covenants set forth in Section 2.01(a)(i) and (ii) (such changes causing more stringent terms) between Company and any creditor and if so, a summary of such material adverse changes; (ii) Company shall deliver to the Bank within seven (7) calendar days after the filing of Company's quarterly financial statements on Form 10-Q or annual financial statements on Form 10-K, as applicable, a schedule identifying unencumbered assets and recourse versus non-recourse liabilities in a consolidating format. Notwithstanding the foregoing quarterly certification requirement set forth in 2.01(b)(i), if Company, at any time intra-quarter, is not in compliance with the financial covenants set forth in Section 2.01(a)(i) and (ii), Company shall promptly notify Bank.

Section 3.01 GENERAL REPRESENTATIONS AND WARRANTIES BY COMPANY. Company hereby represents, warrants and covenants that, as of the date hereof and hereafter:

(a) Company is not, and neither the execution of nor performance of any obligations of Company under this Financial Covenants Supplement shall, with the passage of time, the giving of notice or otherwise, cause Company to be in violation of its charter or articles of incorporation, by-laws, any applicable law or any material administrative regulation; provided, however, that violation of such material administrative regulation shall not include any regulatory violation that does not adversely impact the ability of Company to perform its obligations under this Financial Covenants Supplement or the Guaranty;

(b) Company has full corporate power and authority and has received all corporate and governmental authorizations and approvals as may be required to enter into and perform the obligations under this Financial Covenants Supplement;

(c) The information given by Company in any document provided in connection with its obligations under this Financial Covenants Supplement is true, accurate and does not contain a material misstatement;

(d) Company shall notify the Bank immediately upon the filing of any current report on Form 8-K that reports a material adverse event affecting Company or its business or operations; and

(e) Company and the Bank consent to the recording of telephone conversations in connection with this Financial Covenants Supplement.

Section 3.02 MISCELLANEOUS.

(a) Sections 5.04 and 5.08 of the Agreement are hereby fully incorporated into, and made a part of this Financial Covenants Supplement, except that for purposes of this Financial Covenants Supplement only, in Sections 5.04 and 5.08 every reference to "Member" is changed to "Company" and every reference to "Agreement" is changed to "Financial Covenants Supplement."

(b) Section 5.05 of the Agreement is hereby fully incorporated into, and made a part of this Financial Covenants Supplement, except that for purposes of this Financial Covenants Supplement only, in Section 5.05 every reference to “Member” is changed to “Company,” except for the reference to the Member’s DID Account which remains as is, and every reference to “Agreement” is changed to “Financial Covenants Supplement.”

(c) For purposes of this Financial Covenants Supplement, documents and electronic records shall be deemed signed by Company when a signature or an electronic signature of an authorized signatory or an authorized facsimile thereof appears on or is associated with the document or electronic record. The Bank may rely on any signature or facsimile thereof which reasonably appears to the Bank to be the signature of an authorized person, including signatures appearing on documents transmitted electronically to and reproduced mechanically at the Bank. The secretary or an assistant secretary of Company shall from time to time furnish to the Bank, on forms provided by the Bank, a certificate detailing the persons then authorized to act for and on behalf of Company in accordance with this Financial Covenants Supplement together with specimen signatures or specimen electronic signatures of such persons. Such certifications are incorporated herein and made a part of this Financial Covenants Supplement and shall continue in effect until expressly revoked in writing by Company notwithstanding that subsequent certifications may authorize additional persons to act for and on behalf of Company.

(d) This Financial Covenants Supplement shall be binding upon and inure to the benefit of the successors and permitted assigns of Company, Member and Bank.

(e) This Financial Covenants Supplement embodies the entire agreement and understanding between the parties hereto relating to the subject matter hereof and supersedes all prior agreements between such parties which relate to such subject matter.

(f) The captions and headings in this Financial Covenants Supplement are for convenience only and shall not be considered as part of or affect the construction or interpretation of any provision of this Financial Covenants Supplement.

(g) All representations, warranties, and covenants by Company contained in this Financial Covenants Supplement or made in writing in any certificate or other writing required to be delivered pursuant to the terms of this Financial Covenants Supplement, shall, at the time made, be true, accurate and complete in all material respects.

(h) NOTICES. Any notice, advice, request, consent, or direction given, made, or withdrawn pursuant to this Financial Covenants Supplement shall be given in writing or by an electronic transmission in such form and provided in accordance with such security procedures or similar protocols as may be established by the Bank, and must be delivered by: (a) hand delivery; (b) certified mail, return receipt requested; (c) internationally recognized overnight courier service, or (d) electronically, to the other party’s respective address given below:

| | |
|---|---|
| If to Company: | Redwood Trust, Inc.<br>One Belvedere Place, Suite 300<br>Mill Valley, California 94941<br>Attention: Secretary<br>email: notices@redwoodtrust.com |
| and to: | Redwood Trust, Inc.<br>One Belvedere Place, Suite 300<br>Mill Valley, California 94941<br>Attention: Treasurer<br>email: notices@redwoodtrust.com |

With a copy to: Kaye Scholer LLP
3 First National Plaza
70 West Madison Street, Suite 4200
Chicago, Illinois 60602
Attention: Daniel J. Hartnett
email: daniel.hartnett@kayescholer.com

If to Bank: Federal Home Loan Bank of Chicago
200 E. Randolph Drive, 18th Floor
Chicago, Illinois 60601
Attention: Credit Department
Email: membernotices@fhlbc.com

All notices, except for electronic notices, shall be deemed to have been delivered when the notice is either refused to be accepted or is received by the party to whom the notice is directed. Notices sent electronically shall be deemed delivered on the same business day on which it is sent electronically (or on the next business day, if such notification is sent out after 5:00 p.m. recipient's time).

IN WITNESS WHEREOF, Company, the Member and the Bank have caused this Financial Covenants Supplement to be signed in their names by their duly authorized officers as of the date first above mentioned.

RWT FINANCIAL, LLC

By: /s/ Christopher J. Abate

Title: Chief Financial Officer Member Number: 03024-7

REDWOOD TRUST, INC.

By: /s/ Christopher J. Abate

Title: Chief Financial Officer

FEDERAL HOME LOAN BANK OF CHICAGO

By: /s/ Michelle Jonson

Name: Michelle Jonson
Title: Senior Vice President

By: /s/Agnes Hardison

Name: Agnes Hardison
Title: Senior Vice President

**Exhibit 10.10**

# GUARANTY

**THIS GUARANTY**, dated July 16, 2014, is given by Redwood Trust, Inc., a Maryland corporation (the "Guarantor"), in favor of the Federal Home Loan Bank of Chicago ("FHLB Chicago"), an instrumentality of the United States of America, located at 200 E. Randolph Drive, Chicago, Illinois 60601.

**1 . Unconditional Guaranty**. In consideration of and to induce FHLB Chicago to make advances and other extensions of credit to RWT Financial, LLC ("Member") pursuant to that certain Advances, Collateral Pledge, and Security Agreement of even date herewith (the "ACPS Agreement"), which is and will be to the direct interest and advantage of the Guarantor, the Guarantor unconditionally guarantees to FHLB Chicago, and its successors and assigns, the prompt payment when due of all of the Member's present and future obligations and liabilities of any kind to FHLB Chicago arising out of the ACPS Agreement heretofore, now, or hereafter made, incurred or created, whether voluntary or involuntary and however arising, whether direct or acquired by FHLB Chicago by assignment or succession, whether originally incurred by or assumed by the Member, absolute or contingent, liquidated or unliquidated, determined or undetermined, and whether the Member may be liable individually or jointly with others, or whether recovery upon such Obligations may be or hereafter become barred by any statute of limitations, or whether such Obligations may be or hereafter become otherwise unenforceable (any and all such obligations and liabilities, the "Obligations").

This Guaranty is unconditional and shall not be affected by the genuineness, validity, regularity or enforceability of the Obligations or any instrument evidencing any Obligations, or by the existence, validity, enforceability, perfection, or extent of any collateral therefor, or by any circumstance relating to the Obligations which might otherwise constitute a defense to this Guaranty. This Guaranty is absolute and unconditional and shall remain in full force and effect and be binding upon the Guarantor and its successors and assigns so long as the ACPS Agreement remains in full force and effect. If at any time any payment by the Member in respect of any Obligations is rescinded or must otherwise be returned for any reason whatsoever, in whole or in part, the Guarantor shall remain liable hereunder in respect of such Obligations as if such payment had not been made, and this Guaranty shall remain in full force and effect or shall be reinstated (as the case may be) with respect to such Obligations.

This is a guaranty of payment and not a guaranty of collection, and the Guarantor agrees that FHLB Chicago may resort to the Guarantor for payment of any of the Obligations whether or not FHLB Chicago has proceeded against any other obligor principally or secondarily liable for any Obligations, including the Member, or against any collateral for the Obligations, and whether or not FHLB Chicago has pursued any other remedy available to it. FHLB Chicago shall not be obligated to file any claim relating to the Obligations, including any claim in the event that the Member becomes subject to a bankruptcy, reorganization or similar proceeding, and the failure of to file any such claim shall not affect the Guarantor's obligations hereunder. The Guarantor also specifically waives all presentments, demands for performance, notices of nonperformance, protests, notices of protest, notices of dishonor, notices of acceptance, and all other notices whatsoever with respect to this Guaranty and of the existence, creation, or incurring of new or additional Obligations. This Guaranty shall not be deemed to supersede or replace any other guaranties given to FHLB Chicago by the Guarantor; and the Obligations guaranteed hereby shall be in addition to any other obligations guaranteed by the Guarantor pursuant to any other agreement or guaranty given to FHLB Chicago and other guaranties of the Obligations.

**2. Consents**. The Guarantor agrees that FHLB Chicago may at any time, and from time to time (a) extend the time of payment of or renew any of the Obligations, (b) receive and hold security for the payment of any Obligations and enforce, waive, release, fail to perfect, sell or otherwise dispose of any such security, (c) release or substitute any other guarantor of any Obligations, or (d) make any agreement with the Member or with any other party or person liable on any of the Obligations, for the extension, renewal, payment, compromise, discharge or release of the Obligations (in whole or in part), or for any modification of the terms thereof or of any agreement between FHLB Chicago and the Member or any such other party or person, without in any way impairing or affecting this Guaranty for any outstanding Obligations. The Guarantor authorizes FHLB Chicago, without notice or demand and without affecting its liability hereunder, from time to time, to assign or transfer the Obligations, to waive, forbear, indulge or take other action or inaction in respect of this Guaranty or the Obligations, or to exercise or not exercise any right or remedy hereunder or otherwise with respect to the Obligations.

**3. Rights; Expenses**. No failure by FHLB Chicago to exercise, and no delay in exercising, any right, remedy or power hereunder shall operate as a waiver thereof, nor shall any single or partial exercise by FHLB Chicago of any right, remedy or power hereunder preclude any other or future exercise of any right, remedy or power. Each and every right, remedy and power hereby granted to FHLB Chicago or allowed by law or other agreement shall be cumulative and not exclusive of any other right, remedy or power. The Guarantor agrees to pay on demand all reasonable out-of-pocket expenses (including the reasonable fees and expenses of FHLB Chicago's counsel) in any way relating to the enforcement or protection of FHLB Chicago's rights under this Guaranty.

**4. Benefit; Member**. The Guarantor will benefit from FHLB Chicago entering transactions with the Member pursuant to the ACPS Agreement, and the Guarantor has determined that the execution and delivery by the Guarantor of this Guaranty is necessary and convenient to the conduct, promotion and attainment of the business of the Guarantor and/or the achievement of some pecuniary and/or other benefit. The Guarantor acknowledges and agrees that it shall have the sole responsibility for obtaining from the Member such information concerning the Obligations and the Member's financial conditions or business operations as the Guarantor may require, and that FHLB Chicago has no duty at any time to disclose to the Guarantor any such information. The Guarantor acknowledges and agrees that it is not necessary for FHLB Chicago to inquire into the powers of the Member or of the officers, directors, partners or agents acting or purporting to act on its behalf, the appropriateness of any transaction for the Member, or the purpose of any transaction, and any Obligations made or created in reliance upon the professed exercise of such powers shall be guaranteed hereunder.

**5. Subrogation**. The Guarantor shall not exercise any rights which it may have or acquire by way of subrogation until all of the Obligations are paid in full to FHLB Chicago. If any amounts are paid to the Guarantor in violation of the foregoing limitation, then such amounts shall be held in trust for the benefit of FHLB Chicago and shall forthwith be paid to FHLB Chicago to reduce the amount of outstanding Obligations, whether matured or unmatured. Subject to the foregoing, upon payment of all of the Obligations to FHLB Chicago, the Guarantor shall be subrogated to the rights of FHLB Chicago against the Member, and FHLB Chicago agrees to take at the Guarantor's expense such actions as the Guarantor may reasonably require to implement such subrogation.

**6. Subordination**. The Guarantor agrees: (a) to subordinate the obligations now or hereafter owed by the Member to the Guarantor (the "Subordinated Debt") to any and all Obligations of the Member to FHLB Chicago now or hereafter existing while this Guaranty is in effect;

provided, that the Guarantor may receive principal and interest payments on the Subordinated Debt so long as (i) no "Event of Default" exists with respect to any sums then due and payable by the Member to FHLB Chicago with respect to the Obligations; (ii) no event or condition which constitutes or which with notice or the lapse or time would constitute an "Event of Default" with respect to the Obligations shall be continuing on or as of the payment date; and (iii) such principal and interest payments on the Subordinated Debt do not cause or would with notice or the lapse of time cause Member to be in default under the Advances Agreement; (b) it will either place a legend indicating such subordination on every note, ledger page or other document evidencing any part of the Subordinated Debt or deliver such documents to FHLB Chicago; and (c) except as permitted by this Section 6, it will not request or accept payment of or any security for any part of the Subordinated Debt, and any proceeds of the Subordinated Debt paid to the Guarantor, through error or otherwise, shall immediately be forwarded to the Bank by the Guarantor, properly endorsed to the order of FHLB Chicago, to apply to the Obligations.

**7. Assignment; Termination**. The Guarantor shall not assign its rights, interest, duties or obligations hereunder to any other person without FHLB Chicago's prior written consent, and any purported transfer without that consent shall be void. None of the terms or provisions of this Guaranty may be waived, amended, supplemented or otherwise modified, and no consent with respect to any departure by the Guarantor from the terms hereof shall be effective, except as set forth in a written instrument executed by the Guarantor and FHLB Chicago.

**8. Taxes**. All payments by the Guarantor hereunder will be made in full without set-off or counterclaim and free and clear of and without withholding or deduction for or on account of any present or future taxes, duties or other charges, unless the withholding or deduction of such taxes or duties is required by law. In any such event, however, the Guarantor shall (a) promptly notify FHLB Chicago in writing of such requirement, (b) pay to the relevant authorities the full amount required to be deducted or withheld (including the full amount required to be deducted or withheld from any additional amount paid to FHLB Chicago pursuant to this paragraph), (c) promptly forward to FHLB Chicago an official receipt (or a certified copy) evidencing such payment, and (d) pay to FHLB Chicago such additional amounts as may be necessary in order that the net amount received by FHLB Chicago after such withholding or deduction shall equal the full amounts of moneys which would have been received by FHLB Chicago in the absence of such withholding or deduction. The Guarantor will pay all stamp, registration, documentation, or other similar taxes payable in connection with this Guaranty and will keep FHLB Chicago indemnified against failure to pay the same.

**9. Payments**. The Guarantor hereby guarantees that the Obligations will be paid to FHLB Chicago without set-off or counterclaim, in lawful currency of the United States of America.

**10. Representations**. The Guarantor represents and warrants: (i) that it has the corporate power to execute this Guaranty and any other document executed or delivered in connection with this Guaranty; (ii) that all the necessary corporate actions have been taken to permit it to give this Guaranty; (iii) that the persons executing this guaranty are duly empowered to do so on the behalf of the Guarantor; (iv) that the execution or performance of this Guaranty is not a breach or violation of any instrument concerning the Guarantor or any agreement to which the Guarantor is a party or any law or regulation to which the Guarantor is subject; (v) that there is not pending or, to its knowledge, threatened against it or any of its affiliates any action, suit or proceeding at law or in equity or before any court, tribunal, governmental body, agency or official or any arbitrator that is likely to affect its ability to perform its obligations under this Guaranty; (vi) that all applicable information that is furnished in writing by or on behalf of it to FHLB Chicago

pursuant to this Guaranty as of the date of the information, is true, accurate and complete in all material respects; (vii) that all governmental and other consents that are required to have been obtained by it with respect to this Guaranty have been obtained and are in full force and effect and all conditions of any such consents have been complied with; and (viii) that this Guaranty constitutes a valid, binding and enforceable agreement against the Guarantor in accordance with its terms.

**11. Delivery Obligations**. The Guarantor shall deliver to FHLB Chicago such information as FHLB Chicago may request from time to time, including without limitation, copies of the quarterly unaudited or annual audited financial statements (prepared in accordance with generally accepted accounting principles in the country in which the entity to which they relate is organized) pertaining to the Guarantor's financial condition, such quarterly reports to be provided within forty-five (45) calendar days after the end of each fiscal quarter and such annual reports to be provided within sixty (60) calendar days after the end of each fiscal year. Such information shall be true, complete, and accurate in all material respects. For the avoidance of doubt, quarterly and annual financial statements required to be delivered hereunder shall be deemed to be delivered by Guarantor to FHLB Chicago upon, the filing of such financial statements with the U.S. Securities and Exchange Commission; provided however, if Guarantor delays its filing beyond the time frames set forth in this Section 11, it will promptly notify Bank of such delay.

**12. Default**. If any of the following events occur, a default ("Default") under this Guaranty shall exist: (a) failure of timely payment or performance of the Obligations (after giving effect to applicable grace periods); (b) a breach of any agreement or representation of Guarantor contained or referred to in this Guaranty; (c) the appointment of a receiver for, assignment for the benefit of creditors of, or the commencement of any insolvency or bankruptcy proceeding by or against the Guarantor; and/or (d) FHLB Chicago determines in good faith, in a commercially reasonable manner, that the prospects for payment or performance of the Obligations by Guarantor are impaired or a material adverse change has occurred in the business or prospects of the Guarantor, financial or otherwise.

If a Default occurs, the Obligations shall be due immediately and payable, without notice, and FHLB Chicago may exercise any rights and remedies as provided in this Guaranty, or as provided at law or equity. The Guarantor shall pay interest on the Obligations from such Default at the highest rate of interest charged on any of the Obligations.

**13. Governing Law; Jurisdiction**. (A) THIS GUARANTY SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE STATUTORY AND COMMON LAW OF THE UNITED STATES AND, TO THE EXTENT FEDERAL LAW INCORPORATES STATE LAW, THE LAWS (EXCLUSIVE OF THE CHOICE OF LAW PROVISIONS) OF THE STATE OF ILLINOIS. WITH RESPECT TO ANY SUIT, ACTION OR PROCEEDING CONCERNING THIS GUARANTY, THE GUARANTOR SUBMITS TO THE EXCLUSIVE JURISDICTION OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, OR IF SUCH ACTION OR PROCEEDING MAY NOT BE BROUGHT IN FEDERAL COURT, THE JURISDICTION OF THE COURTS OF THE STATE OF ILLINOIS LOCATED IN THE CITY OF CHICAGO. THE GUARANTOR SPECIFICALLY AND IRREVOCABLY WAIVES (I) ANY OBJECTION WHICH IT MAY HAVE AT ANY TIME TO THE LAYING OF VENUE OF ANY SUIT, ACTION OR PROCEEDING BROUGHT IN SUCH COURTS, (II) ANY CLAIM THAT THE SAME HAS BEEN BROUGHT IN AN INCONVENIENT FORUM, AND (III) THE RIGHT TO OBJECT

THAT SUCH COURTS DO NOT HAVE JURISDICTION OVER IT. THE GUARANTOR WAIVES PERSONAL SERVICE OF ANY SUMMONS, COMPLAINT OR OTHER PROCESS, WHICH MAY BE MADE BY ANY OTHER MEANS PERMITTED BY ILLINOIS LAW, INCLUDING, WITHOUT LIMITATION, BY REGISTERED MAIL DIRECTED TO THE GUARANTOR'S PERSONAL RESIDENCE.

(b) TO THE EXTENT PERMITTED BY APPLICABLE LAW, THE GUARANTOR BY EXECUTION HEREOF, KNOWINGLY, VOLUNTARILY AND INTENTIONALLY WAIVES ANY RIGHT IT MAY HAVE TO A TRIAL BY JURY IN RESPECT OF ANY LITIGATION BASED ON, OR ARISING OUT OF, UNDER OR IN CONNECTION WITH THIS GUARANTY. THIS PROVISION IS A MATERIAL INDUCEMENT TO FHLB CHICAGO TO ACCEPT THIS GUARANTY.

**14. Miscellaneous**. (a) This Guaranty contains the entire and exclusive agreement of the parties hereto with reference to the matters discussed herein. This Guaranty supersedes all prior drafts and communications with respect thereto. The headings of paragraphs herein are inserted only for convenience and shall in no way define, describe or limit the scope or intent of any provision of this Guaranty. If any term or provision of this Guaranty shall be deemed prohibited by or invalid under any applicable law, such provision shall be invalidated without affecting the remaining provisions of this Guaranty.

(b) Regardless of any other provision of this Guaranty, if for any reason the effective interest on any of the Obligations should exceed the maximum lawful interest, the effective interest shall be deemed reduced to and shall be such maximum lawful interest, and any sums of interest which have been collected in excess of such maximum lawful interest shall be applied as a credit against the unpaid principal balance of the Obligations. Monies received from any source by FHLB Chicago for application toward payment of the Obligations may be applied to such Obligations in any manner or order deemed appropriate in the sole discretion of FHLB Chicago.

**IN WITNESS WHEREOF**, this Guaranty has been duly executed and delivered by the Guarantor to FHLB Chicago as of the date first above written.

**REDWOOD TRUST, INC.**

By: /s/ Christopher J. Abate

Name: Christopher J. Abate

Title: Chief Financial Officer

Date: July 16, 2014

Address for notices:

Redwood Trust, Inc.
One Belvedere Place, Suite 300
Mill Valley, California 94941
Attention: Secretary
Email: notices@redwoodtrust.com

and to:

Redwood Trust, Inc.
One Belvedere Place, Suite 300
Mill Valley, California 94941
Attention: Treasurer
Email: notices@redwoodtrust.com

With a copy to:

Kaye Scholer LLP
Three First National Plaza
70 West Madison Street, Suite 4200
Chicago, Illinois 60602
Attention: Daniel J. Hartnett
Email: daniel.hartnett@kayescholer.com

**EXHIBIT 31.1**

**CHIEF EXECUTIVE OFFICER CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Martin S. Hughes, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q 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 officer 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)) and internal control over the financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) 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

   d) 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 (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer 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: August 8, 2014

/s/ MARTIN S. HUGHES

Martin S. Hughes
Chief Executive Officer

EXHIBIT 31.2

**CHIEF FINANCIAL OFFICER CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Christopher J. Abate, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q 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 officer 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)) and internal control over the financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) 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

   d) 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 (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer 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: August 8, 2014

/S/ CHRISTOPHER J. ABATE

Christopher J. Abate
Chief Financial Officer

**EXHIBIT 32.1**

**CERTIFICATION**

Pursuant to 18 U.S.C. §1350, the undersigned officer of Redwood Trust, Inc. (the “Registrant”) hereby certifies that the Registrant’s Quarterly Report on Form 10-Q for the three months ended June 30, 2014 (the “Quarterly Report”) fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

Date: August 8, 2014

/S/ MARTIN S. HUGHES
Martin S. Hughes
Chief Executive Officer

The foregoing certification is being furnished solely pursuant to 18 U.S.C. §1350 and is not being filed as part of the Quarterly Report or as a separate disclosure document.

**EXHIBIT 32.2**

**CERTIFICATION**

Pursuant to 18 U.S.C. §1350, the undersigned officer of Redwood Trust, Inc. (the "Registrant") hereby certifies that the Registrant's Quarterly Report on Form 10-Q for the three months ended June 30, 2014 (the "Quarterly Report") fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

Date: August 8, 2014

/S/ CHRISTOPHER J. ABATE
Christopher J. Abate
Chief Financial Officer

The foregoing certification is being furnished solely pursuant to 18 U.S.C. §1350 and is not being filed as part of the Quarterly Report or as a separate disclosure document.