REDWOOD TRUST INC
Form 10-Q
August 08, 2007

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

FORM 10-Q

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

For the Quarterly Period Ended: June 30, 2007

OR

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

For the transition period from _______ to _______

Commission file number 1-13759

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

Maryland	**68-0329422**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

One Belvedere Place, Suite 300
Mill Valley, California 94941

(Address of Principal Executive Offices) (Zip Code)

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

Securities registered pursuant to Section 12(g) of the Act:

Title of Each Class:	**Name of Exchange on Which Registered:**
Common Stock, par value $0.01 per share	New York Stock Exchange

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x Accelerated Filer o Non-Accelerated Filer o

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

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

Common Stock, $0.01 par value per share	27,937,406 as of August 7, 2007

REDWOOD TRUST, INC.
2007 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, 2007	December 31, 2006
ASSETS		
Real estate loans	$ 8,377,474	$ 9,352,107
Real estate securities	3,725,772	3,232,767
Other real estate investments	34,168	—
Non-real estate investments	80,000	—
Cash and cash equivalents	82,626	168,016
Total earning assets	12,300,040	12,752,890
Restricted cash	206,664	112,167
Accrued interest receivable	57,337	70,769
Derivative assets	40,713	26,827
Deferred tax asset	4,660	5,146
Deferred asset-backed securities issuance costs	48,532	42,468
Other assets	23,369	20,206
Total Assets	$ 12,681,315	$ 13,030,473
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Redwood debt	$ 848,662	$ 1,856,208
Asset-backed securities issued	10,675,469	9,979,224
Accrued interest payable	48,473	50,590
Derivative liabilities	6,250	6,214
Accrued expenses and other liabilities	55,515	16,832
Dividends payable	20,862	18,715
Subordinated notes	150,000	100,000
Total liabilities	11,805,231	12,027,783
Commitments and contingencies (Note 17)		
STOCKHOLDERS' EQUITY		
Common stock, par value $0.01 per share, 50,000,000 shares authorized; 27,816,200 and 26,733,460 issued and outstanding	279	267
Additional paid-in capital	964,944	903,808
Accumulated other comprehensive income (loss)	(80,913)	93,158
Cumulative earnings	838,736	809,011
Cumulative distributions to stockholders	(846,962)	(803,554)
Total stockholders' equity	876,084	1,002,690
Total Liabilities and Stockholders' Equity	$ 12,681,315	$ 13,030,473

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share data) (Unaudited)	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Interest Income				
Real estate loans	$ 119,576	$ 154,972	$ 246,427	$ 321,875
Real estate securities	95,193	60,395	178,651	116,897
Other real estate investments	669	—	3,134	—
Non-real estate investments	464	—	464	—
Cash and cash equivalents	3,756	2,871	6,088	5,348
Total interest income	219,658	218,238	434,764	444,120
Interest Expense				
Redwood debt	(22,700)	(1,822)	(53,794)	(3,894)
Asset-backed securities issued	(140,541)	(171,697)	(275,487)	(350,280)
Subordinated notes	(2,516)	—	(4,572)	—
Total interest expense	(165,757)	(173,519)	(333,853)	(354,174)
Net Interest Income	53,901	44,719	100,911	89,946
Operating expenses	(12,772)	(16,037)	(30,554)	(28,619)
Realized gains on sales and calls, net	2,738	8,988	3,884	10,050
Market valuation adjustments, net	(29,430)	(2,995)	(39,694)	(5,927)
Net income before provision for income taxes	14,437	34,675	34,547	65,450
Provision for income taxes	(3,021)	(3,265)	(4,822)	(6,025)
Net Income	$ 11,416	$ 31,410	$ 29,725	$ 59,425
Basic earnings per share:	$ 0.42	$ 1.23	$ 1.10	$ 2.34
Diluted earnings per share:	$ 0.41	$ 1.20	$ 1.06	$ 2.29
Regular dividends declared per common share	$ 0.75	$ 0.70	$ 1.50	$ 1.40
Special dividends declared per common share	$ —	$ —	$ —	$ —
Total dividends declared per common share	$ 0.75	$ 0.70	$ 1.50	$ 1.40
Basic weighted average shares outstanding	27,405,284	25,496,552	27,132,001	25,349,853
Diluted weighted average shares outstanding	28,164,944	26,108,975	27,917,502	25,909,923

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands) (Unaudited)	**Three Months Ended June 30, 2007**	**2006**	**Six Months Ended June 30, 2007**	**2006**
Net Income	$ 11,416	$ 31,410	$ 29,725	$ 59,425
Other Comprehensive (Loss) Income:				
Net unrealized (losses) gains on available-for-sale securities	(101,745)	6,679	(194,430)	(1,380)
Reclassification adjustment for net (gains) losses included in net income	7,058	(1,342)	6,945	656
Unrealized (losses) gains on cash flow hedges, net	19,952	10,128	13,814	24,315
Reclassification of net realized cash flow hedge losses (gains) to interest expense on asset-backed securities issued and realized gains on sales and calls	5	(6,119)	(400)	(6,385)
Total Other Comprehensive (Loss) Income	(74,730)	9,346	(174,071)	17,206
Comprehensive (Loss) Income	$ (63,314)	$ 40,756	$ (144,346)	$ 76,631

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Six Months Ended June 30, 2007

(In thousands, except share data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2006	26,733,460	$ 267	$ 903,808	$ 93,158	$ 809,011	$ (803,554)	$ 1,002,690
Net income	—	—	—	—	29,725	—	29,725
Net unrealized gain/reclassification on assets AFS	—	—	—	(187,485)	—	—	(187,485)
Net unrealized gain/reclassification on interest rate agreements	—	—	—	13,414	—	—	13,414
Issuance of common stock:							
Dividend reinvestment & stock purchase plans	1,004,165	10	52,054	—	—	—	52,064
Employee option & stock purchase plan	78,575	2	330	—	—	—	332
Non-cash equity award compensation	—	—	8,752	—	—	—	8,752
Common dividends declared	—	—	—	—	—	(43,408)	(43,408)
June 30, 2007	27,816,200	$ 279	$ 964,944	$ (80,913)	$ 838,736	$ (846,962)	$ 876,084

For the Six Months Ended June 30, 2006

(In thousands, except share data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2005	25,132,625	$ 251	$ 824,365	$ 73,731	$ 681,479	$ (644,866)	$ 934,960
Net income	—	—	—	—	59,425	—	59,425
Net unrealized loss/reclassification on assets AFS	—	—	—	(724)	—	—	(724)
Net unrealized gain/reclassification on interest rate agreements	—	—	—	17,930	—	—	17,930
Issuance of common stock:							

Dividend reinvestment & stock purchase plans	485,101	5	20,497	—	—	—	20,502
Employee option & stock purchase plan	52,257	1	387	—	—	—	388
Non-cash equity award compensation	(2,430)	—	8,647	—	—	—	8,647
Common dividends declared	—	—	—	—	—	(36,862)	(36,862)
June 30, 2006	25,667,553	$ 257	$ 853,896	$ 90,937	$ 740,904	$ (681,728)	$ 1,004,266

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

	Six Months Ended June 30,	
(In thousands)	**2007**	**2006**
(Unaudited)		
Cash Flows From Operating Activities:		
Net income	$ 29,725	$ 59,425
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs	(32,749)	(31,080)
Depreciation and amortization of non-financial assets	830	545
Provision for credit losses	6,329	(2,330)
Non-cash equity award compensation	8,752	8,647
Net recognized losses (gains) and valuation adjustments	35,810	(4,123)
Purchases of other real estate investments - trading	(40,818)	—
Purchases of non-real estate investments - trading	(80,000)	—
Principal payments on other real estate investments - trading	7,431	—
Net change in:		
Accrued interest receivable	13,432	9,671
Deferred income taxes	568	281
Other assets	4,111	(683)
Accrued interest payable	(2,117)	5,900
Accrued expenses and other liabilities	38,683	937
Net cash (used in) provided by operating activities	(10,013)	47,190
Cash Flows From Investing Activities:		
Purchases of real estate loans held-for-investment	(1,091,496)	(325,316)
Proceeds from sales of real estate loans held-for-investment	2,191	8,408
Principal payments on real estate loans held-for-investment	2,025,662	3,733,573
Purchases of real estate securities available-for-sale	(1,011,181)	(496,822)
Proceeds from sales of real estate securities available-for-sale	175,559	176,432
Principal payments on real estate securities available-for-sale	160,737	101,803
Proceeds from sales of other real estate investments - trading	2,237	—
Net increase in restricted cash	(94,497)	(13,806)
Net cash provided by investing activities	169,212	3,184,272
Cash Flows From Financing Activities:		
Net (repayments) borrowings on Redwood debt	(1,007,546)	359,676
Proceeds from issuance of asset-backed securities	3,332,925	288,709
Deferred asset-backed security issuance costs	(19,147)	(3,383)
Repayments on asset-backed securities	(2,609,157)	(3,934,557)
Proceeds from issuance of subordinated notes	50,000	—
Net (purchases) proceeds from interest rate agreements	(2,798)	4,297
Net proceeds from issuance of common stock	52,396	20,890
Dividends paid	(41,262)	(36,488)
Net cash used in financing activities	(244,589)	(3,300,856)
Net decrease in cash and cash equivalents	(85,390)	(69,394)

Cash and cash equivalents at beginning of period		168,016		175,885
Cash and cash equivalents at end of period	$	82,626	$	106,491
Supplemental Disclosure of Cash Flow Information:				
Cash paid for interest	$	335,970	$	348,274
Cash paid for taxes	$	8,480	$	4,099
Non-Cash Financing Activity:				
Dividends declared but not paid	$	20,862	$	17,967

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. Our primary focus is credit-enhancing residential and commercial real estate loans. We credit-enhance loans by acquiring and managing the first-loss and other credit-sensitive securities that bear the bulk of the credit risk of securitized loans.

We seek to invest in assets that have the potential to generate high long-term cash flow returns to help support our goal of distributing an attractive level of dividends per share to shareholders over time. For tax purposes, we are structured as a real estate investment trust (REIT).

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. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2007 and December 31, 2006 and for the three and six months ended June 30, 2007 and 2006. The accompanying consolidated financial statements are unaudited. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and, in our opinion, reflect all adjustments necessary for a fair statement of our financial position, results of operations, and cash flows. These consolidated financial statements and notes thereto should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006. The results for the six months ended June 30, 2007 are not necessarily indicative of the expected results for the year ended December 31, 2007. Certain amounts for prior years have been reclassified to conform to the June 30, 2007 presentation.

These consolidated financial statements include the accounts of Redwood Trust, Inc. (Redwood Trust) and its direct and indirect wholly-owned subsidiaries (collectively, Redwood). All inter-company balances and transactions have been eliminated in consolidation. A number of Redwood Trust's subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT mean Redwood Trust and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We currently operate two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the Sequoia securitization entities. Our Acacia program involves the resecuritization of mortgage-backed securities and other types of financial assets through the issuance of collateralized debt obligations (CDOs). References to Acacia refer collectively to all of the Acacia CDO issuing entities.

Under the provisions of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), we treat the securitizations we sponsor as financings, as under these provisions we have retained effective control over these loans and securities. Control is maintained through our active management of the assets in the securitization entities, our retained asset transfer discretion, our ability to direct certain servicing decisions, or a combination of the foregoing. Accordingly, the underlying loans and securities owned by these securitization entities are shown on our consolidated balance sheets under real estate loans, real estate securities, and the asset-back securities (ABS) issued to third parties are shown on our consolidated balance sheets under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities and interest expense on the ABS issued. Any Sequoia ABS acquired by Redwood or Acacia from Sequoia entities and any Acacia ABS acquired by Redwood for its own portfolio are eliminated in consolidation and thus are not shown separately on our consolidated balance sheets and the associated income and expense are not shown separately on our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 2. Summary of Significant Accounting Policies - (continued)

Use of Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States of America (GAAP) requires us to make a significant number of estimates. These include fair market value of certain assets, amount and timing of credit losses, prepayment assumptions, and other items 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., market values due to changes in supply and demand, credit performance, prepayments, interest rates, or other reasons; yields due to changes in credit outlook and loan prepayments) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences may be material.

Real Estate Loans

Residential and Commercial Real Estate Loans: Held-for-Investment

Real estate loans include residential and commercial real estate loans. Real estate loans held-for-investment are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for credit losses.

Coupon interest is recognized as revenue when earned and deemed collectible. We accrue interest on loans until they are more than 90 days past due at which point they are placed on nonaccrual status. Purchase discounts and premiums related to real estate loans are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the loans pursuant to the provisions discussed below. Gains or losses on the sale of real estate loans are based on the specific identification method.

Pursuant to Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (FAS 91), we use the interest method to determine an effective yield and amortize the premium or discount on loans. For loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For 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 to calculate an effective yield to amortize the premium or discount.

We may exercise our right to call ABS issued by entities sponsored by us and may subsequently sell the underlying loans to third parties. For balance sheet purposes, we reclassify held-for-investment loans to held-for-sale loans once we determine which loans will be sold to third parties. In our consolidated statements of cash flows, sales of loans are reported as sales of loans held-for-investment as the acquisition of loans were reported as purchases of loans held-for-investment.

Residential and Commercial Real Estate Loans: Held-for-Sale

Residential and commercial real estate loans that we are marketing for sale are classified as real estate loans held-for-sale. These are carried at the lower of cost or fair market value on a loan-by-loan basis. Any market valuation adjustments on these loans are recognized in valuation adjustments net, in our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 2. Summary of Significant Accounting Policies - (continued)

Real Estate Loans - Reserve for Credit Losses

For consolidated real estate loans held-for-investment, we establish and maintain credit reserves based on estimates of credit losses inherent in these loan portfolios as of the reporting date. To calculate the credit reserve, 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 of the consolidated loans, loan pools, or individual loans. See *Note 8* for a discussion of the reserves for credit losses.

We follow the guidelines of Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation* (SAB 102), Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), and Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures* (FAS 118) in setting credit reserves for our real estate loans.

The following factors are considered and applied in such determinations:

- Ongoing analyses of loans — including, but not limited to, the age of loans, underwriting standards, business climate, economic conditions, geographical considerations, and other observable data;
- Historical loss rates and past performance of similar loans;
- Relevant environmental factors;
- 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 the borrowers' ability to meet obligations;
- Ongoing evaluations of fair market values of collateral using current appraisals and other valuations; and
- Discounted cash flow analyses.

Once we determine applicable default amounts, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an effective loss confirmation period. This period is defined as the range of time between the probable occurrence of a credit loss (such as the initial deterioration of the borrower's financial condition) and the confirmation of that loss (the actual impairment or charge-off of the loan). The losses expected to occur within the estimated loss confirmation period are the basis of our credit reserves because we believe those losses exist as of the reported date of the financial statements. We re-evaluate the level of our credit reserves on at least a quarterly basis, and we record provision, charge-offs, and recoveries monthly.

We do not maintain a loan repurchase reserve, as any risk of loss due to loan repurchases (i.e., due to breach of representations) would normally be covered by recourse to the companies from whom we acquired the loans.

Real Estate Securities

Real estate securities include residential, commercial, and CDO securities. Real estate securities are classified as available-for-sale (AFS) and are carried at their estimated fair market values. Cumulative unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss) in our consolidated statements of stockholders' equity. Upon sale this accumulated other comprehensive income (loss) is reclassified into earnings on the specific identification method.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 2. Summary of Significant Accounting Policies - (continued)

Coupon interest is recognized as revenue when earned and deemed collectible. Purchase discounts and premiums related to the securities are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the securities pursuant to the provisions discussed below. Gains or losses on the sale of securities are based on the specific identification method.

When recognizing revenue on AFS securities, we employ the interest method to account for purchase premiums, discounts, and fees associated with these securities. For securities rated AAA or AA, we use the interest method as prescribed under FAS 91, while for securities rated A or lower we use the interest method as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). The use of these methods requires us to project cash flows over the remaining life of each asset. These projections include assumptions about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review and make adjustments to our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience. Actual maturities of AFS securities are generally shorter than stated contractual maturities. All of our stated maturities are greater than ten years. Actual maturities of the AFS securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal. There can be no assurance that our assumptions used to estimate future cash flows or the current period's yield for each asset would not change in the near term, and the change could be material.

Yields recognized for GAAP for each security vary as a function of credit results, prepayment rates, and, for our securities with variable rate coupons, 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), 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), the yield over the remaining life of the security may be adjusted downward or we may have an other-than-temporary impairment.

For determining other-than-temporary impairment on our real estate securities, we use the guidelines prescribed under EITF 99-20, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), and Staff Accounting Bulletin No. 5(m), *Other-Than-Temporary Impairment for Certain Investments in Debt and Equity Securities* (SAB 5(m)). Any other-than-temporary impairments are reported under market valuation adjustments, net in our consolidated statements of income. For real estate securities subject to Emerging Issues Task Force of the Financial Accounting Standards Board 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1), we assess whether a drop in fair market value below the cost of the real estate security should be deemed as other-than-temporary impairment. If we have the ability and intent to hold a real estate security for a reasonable period of time sufficient for a forecasted recovery of fair market value up to (or beyond) the cost of the investment, we do not deem that unrealized loss an other-than-temporary impairment.

In the footnotes to the consolidated financial statements, we disclose information on our real estate securities portfolio based on the underlying residential, commercial, and CDO assets. We also provide a further breakdown of these securities by investment-grade securities (IGS, those rated BBB to AAA) and credit-enhancement securities (CES, those rated non-rated to BB, also referred to as first-loss, second-loss, and third-loss securities) based on their current credit rating.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 2. Summary of Significant Accounting Policies - (continued)

Other Real Estate Investments

Other real estate investments include interest-only certificates (IOs), net interest margin securities (NIMs), and residual securities (residuals). At the conclusion of the first quarter of 2007, we classified these investments as trading securities. With the adoption of *Statement of Financial Accounting Standards* No. 155, *Accounting for Certain Hybrid Financial Investments*, (FAS 155) IOs, NIMs and residuals may contain embedded derivatives which would require bifurcation and separate valuation through the income statement. We have elected to treat these investments as trading securities under FAS 115 rather than bifurcate the embedded derivative component. Trading securities are reported on our consolidated balance sheet at their estimated fair market values with changes in fair market values reported through our consolidated statements of income through market valuation adjustments.

Total income recognized in current period earnings on these investments equals coupon interest earned plus the change in fair market value. Interest income is equal to the instruments' yield based on market expectations.

Non-Real Estate Investments

Non-real estate investments represents a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial statements purposes. We have classified this investment as a trading security that is recorded on our consolidated balance sheets at its estimated fair market value. Management considers the GIC's fair market value to approximate contract value, as the interest rate is variable at LIBOR minus a spread and resets on a monthly basis. Changes in fair market value are reported through our consolidated statements of income through market valuation adjustments. See *Note 6* for further discussion of our non-real estate investments.

Cash and Cash Equivalents

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

Derivative Financial Instruments

All derivative financial instruments are reported at fair market value on our consolidated balance sheets. Those with a positive value to us are reported as an asset and those with a negative value to us are reported as a liability. Whether changes in the fair market value of these instruments are reported through our income statement depends on the type of derivative and the accounting treatment chosen.

We currently enter into interest rate agreements to help manage some of our interest rate risks. We report our interest rate agreements at fair market value. We may elect hedge accounting treatment under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), or we may account for these as trading instruments. Net purchases and proceeds from interest rate agreements are classified within cash flows from financing activities within the consolidated statement of cash flows together with the items the interest rate agreements hedge.

We designate an interest rate agreement as (1) a hedge of the fair market value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge), or (3) held for trading (trading instrument).

In a cash flow hedge, the effective portion of the change in the fair market value of the hedging derivative is recorded in accumulated other comprehensive income (loss) and is subsequently reclassified into earnings when the hedging relationship is terminated. The ineffective portion of the cash flow hedge is recognized immediately in earnings. We use the dollar-offset method to determine the amount of ineffectiveness, and we anticipate having some ineffectiveness in our hedging program, as not all terms of our hedges and not all terms of our hedged items match perfectly.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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Note 2. Summary of Significant Accounting Policies - (continued)

We will discontinue hedge accounting when (1) we determine that the derivative is no longer expected to be effective in offsetting changes in the fair market value or cash flows of the designated hedged item; (2) the derivative expires or is sold, terminated, or exercised; (3) the derivative is de-designated as a fair value or cash flow hedge; or (4) it is probable that the forecasted transaction will not occur by the end of the originally specified time period.

As of each period end, we may also have outstanding commitments to purchase real estate loans. These commitments are accounted for as derivatives under Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149), when applicable. These are classified as trading instruments and changes in fair market value of the purchase commitments are recorded through valuation adjustments in the consolidated statements of income.

Beginning in the first quarter of 2007, we entered into credit default swap agreements. A credit default swap is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed rate fee or premium over the term of the contract. Under FAS 133, credit default swaps are accounted for as trading instruments.

See *Note 7* for a further discussion of our derivative financial instruments.

Restricted Cash

Restricted cash includes principal and interest payments from real estate loans and securities owned by consolidated securitization entities that are collateral for, or payable to, owners of ABS issued by those entities and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization trusts prior to purchase of real estate loans and securities or the redemption of outstanding ABS issued.

Accrued Interest Receivable

Accrued interest receivable represents interest that is due and payable to us. This is generally received within the next month.

Deferred Tax Assets

Income recognition for GAAP and tax differ in material respects. As a result, we may recognize taxable income in periods prior to recognizing the income for GAAP. When this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. When the income is then realized under GAAP in future periods, the deferred tax asset is recognized as an expense. Our deferred tax assets are generated by differences in GAAP and tax income at our taxable subsidiaries.

Deferred Asset-Backed Securities Issuance Costs

ABS issuance costs are costs associated with the issuance of ABS from securitization entities we sponsor. These costs typically include underwriting, rating agency, legal, accounting, and other fees. Deferred ABS issuance costs are reported on our consolidated balance sheets as deferred charges and are amortized as an adjustment to consolidated interest expense using the interest method based on the actual and estimated repayment schedules of the related ABS issued under the principles prescribed in Accounting Practice Bulletin 21, *Interest on Receivables and Payables* (APB 21).

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 2. Summary of Significant Accounting Policies - (continued)

Other Assets

Other assets on our consolidated balance sheets include real estate owned (REO), fixed assets, purchased interest, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair market value.

Redwood Debt

Redwood debt is currently all short-term debt collateralized by loans and securities. We report this debt at its unpaid principal balance.

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote securitization entities sponsored by Redwood. These ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium. Our exposure to loss from consolidated securitization entities (such as Sequoia and Acacia) is limited (except, in some circumstances, for limited loan repurchase obligations) to our net investment in securities we have acquired from these entities. Sequoia and Acacia assets are held in the custody of trustees. 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. ABS obligations are payable solely from the assets of these entities and are non-recourse to Redwood.

Subordinated Notes

Subordinated notes includes subordinated notes (trust preferred securities) and subordinated notes. Both are unsecured debt, requiring quarterly interest payments at a floating rate equal to LIBOR plus a spread until they are redeemed in whole, or mature at a future date. These notes contain an earlier optional redemption date without penalty.

Earnings per Share

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

The following table provides reconciliation of denominators of the basic and diluted earnings per share computations.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 2. Summary of Significant Accounting Policies - (continued)

Basic and Diluted Earnings per Share

	Three Months Ended June 30,				Six Months Ended June 30,			
(In thousands, except share data)	**2007**		**2006**		**2007**		**2006**	
Denominators:								
Denominator for basic earnings per share is equal to the weighted average number of common shares outstanding during the period		27,405,284		25,496,552		27,132,001		25,349,853
Adjustments for diluted earnings per share are:								
Net effect of dilutive stock options		759,660		612,423		785,501		560,070
Denominator for diluted earnings per share		28,164,944		26,108,975		27,917,502		25,909,923
Basic Earnings Per Share:	$	0.42	$	1.23	$	1.10	$	2.34
Diluted Earnings Per Share:	$	0.41	$	1.20	$	1.06	$	2.29

Pursuant to EITF 03-6, *Participating Securities and the Two — Class Method under FASB No. 128* (EITF 03-6), we determined that there was no allocation of income for our outstanding stock options as they were antidilutive for the three and six months ended June 30, 2007 and 2006. There were no other participating securities, as defined by EITF 03-6, during the three and six months ended June 30, 2007 and 2006. For the three months ended June 30, 2007 and 2006, the number of outstanding stock options that were antidilutive totaled 449,105 and 465,980 respectively. For the six months ended June 30, 2007 and 2006, the number of outstanding stock options that were antidilutive totaled 252,109, and 466,166 respectively.

Other Comprehensive Income (Loss)

Current period net unrealized gains and losses on real estate securities available-for-sale, and interest rate agreements classified as cash flow hedges are reported as components of other comprehensive income (loss) on our consolidated statements of comprehensive income (loss). Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive income (loss) are adjusted for the effects of tax and may create deferred tax assets or liabilities.

Stock-Based Compensation

As of June 30, 2007 and December 31, 2006, we had one stock-based employee compensation plan and one employee stock purchase plan. These plans, and associated stock options and other equity awards, are described more fully in *Note 16*.

We adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (FAS 123R), on January 1, 2006. With the adoption of FAS 123R, the grant date fair market value of all remaining unvested stock compensation awards (stock options, deferred stock units, and restricted stock) are expensed on the consolidated statements of income over the remaining vesting period.

The Black-Scholes option-pricing model was used in determining fair market values of option grants accounted for under FAS 123R. The model requires the use of inputs such as strike price, and assumptions such as expected life, risk free rate of return, and stock price volatility. Options are generally granted over the course of the calendar year. The stock price volatility assumption is based on the historical volatility of our common stock. Certain options have dividend equivalent rights (DERs) and, accordingly, the assumed dividend yield was zero for these options. Other options granted have no DERs and the assumed dividend yield was 10%.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 2. Summary of Significant Accounting Policies - (continued)

The following table describes the weighted average of assumptions used for calculating the value of options granted for the three and six months ended June 30, 2007 and 2006.

Weighted Average Assumptions used for Valuation of Options under FAS 123R Granted during period

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Stock price volatility	27.2%	—	25.5%	25.7%
Risk free rate of return (5 yr Treasury Rate)	4.87%	—	4.58%	4.75%
Average life	5 years	—	6 years	5 years
Dividend yield	10.00%	—	10.00%	10.00%

Note 3. Real Estate Loans

We acquire residential real estate loans from third party originators. A portion of these loans are sold to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS. The remainder of the loans we invest in are held and financed with Redwood debt and equity. At June 30, 2007, we transferred $13 million (of outstanding principal) of residential delinquent loans from held-for-investment to held-for-sale as we are actively marketing these loans for sale.

The following tables summarize the carrying value of the residential and commercial real estate loans, as reported on our consolidated balance sheets at June 30, 2007 and December 31, 2006.

Real Estate Loans Composition

(In thousands)	June 30, 2007	December 31, 2006
Residential real estate loans - held-for-sale	$ 9,410	$ —
Residential real estate loans - held-for-investment	8,342,237	9,323,935
Total residential real estate loans	8,351,647	9,323,935
Commercial real estate loans - held-for-investment	25,827	28,172
Total real estate loans	$ 8,377,474	$ 9,352,107

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 3. Real Estate Loans - (continued)

Real Estate Loans Carrying Value -Held-for-Investment

June 30, 2007 (In thousands)	**Residential Real Estate Loans**	**Commercial Real Estate Loans**	**Total**
Current face	$ 8,256,759	$ 38,311	$ 8,295,070
Unamortized premium (discount)	101,894	(1,995)	99,899
Discount designated as credit reserve	—	(8,141)	(8,141)
Amortized cost	8,358,653	28,175	8,386,828
Reserve for credit losses	(16,416)	(2,348)	(18,764)
Carrying value	$ 8,342,237	$ 25,827	$ 8,368,064

December 31, 2006 (In thousands)	**Residential Real Estate Loans**	**Commercial Real Estate Loans**	**Total**
Current face	$ 9,212,002	$ 38,360	$ 9,250,362
Unamortized premium (discount)	132,052	(2,047)	130,005
Discount designated as credit reserve	—	(8,141)	(8,141)
Amortized cost	9,344,054	28,172	9,372,226
Reserve for credit losses	(20,119)	—	(20,119)
Carrying value	$ 9,323,935	$ 28,172	$ 9,352,107

Of the $8.3 billion of face and $102 million of unamortized premium on our residential real estate loans at June 30, 2007, $3.5 billion of face and $83 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. At December 31, 2006, the residential loans acquired prior to July 1, 2004 had face and unamortized premium balances of $5.2 billion and $104 million, respectively. For these residential loans, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. During the first half of 2007, 32% of these residential loans prepaid and we amortized 20% of the premium. For residential loans acquired after July 1, 2004, the face and unamortized premium was $4.8 billion and $19 million at June 30, 2007 and $4.0 billion and $28 million at December 31, 2006, respectively. For these residential loans, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

Residential real estate loans are either sold to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS or are held and financed with Redwood debt. The table below presents information regarding real estate loans pledged under our borrowing agreements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 3. Real Estate Loans - (continued)

Real Estate Loans Pledged and Unpledged

(In thousands)	June 30, 2007 Face Value	June 30, 2007 Carrying Value	December 31, 2006 Face Value	December 31, 2006 Carrying Value
Unpledged	$ 175,965	$ 163,789	$ 120,578	$ 111,231
Pledged for Redwood debt:				
Repurchase (repo) agreements	506,932	506,576	978,713	982,629
Commercial paper	204,825	207,135	301,827	302,615
Owned by securitization entities, financed through the issuance of ABS	7,419,895	7,499,974	7,849,244	7,955,632
Carrying value	$ 8,307,617	$ 8,377,474	$ 9,250,362	$ 9,352,107

Note 4. Real Estate Securities

The real estate securities shown on our consolidated balance sheets include residential, commercial, and CDO securities acquired from securitizations sponsored by others. The table below presents the carrying value (which equals fair market value as these are available-for-sale securities (AFS)) of our securities that are included in our consolidated balance sheets as of June 30, 2007 and December 31, 2006, by type of securities, and by credit rating of investment-grade (IGS) and below investment-grade (CES).

Securities (AFS) — Underlying Collateral Characteristics

June 30, 2007 (In thousands)	CES	IGS	Total AFS Securities
Residential securities:			
Prime	$ 569,789	$ 869,884	$ 1,439,673
Alt-a	172,356	855,555	1,027,911
Subprime	2,830	437,507	440,337
Total residential securities	744,975	2,162,946	2,907,921
Commercial securities	450,941	111,144	562,085
CDO securities	21,133	234,633	255,766
Total securities	$ 1,217,049	$ 2,508,723	$ 3,725,772

December 31, 2006 (In thousands)	CES	IGS	Total AFS Securities
Residential securities:			

Prime	$ 555,369	$ 723,247	$ 1,278,616
Alt-a	156,859	455,550	612,409
Subprime	9,303	518,453	527,756
Total residential securities	721,531	1,697,250	2,418,781
Commercial securities	448,060	119,613	567,673
CDO securities	21,964	224,349	246,313
Total securities	$ 1,191,555	$ 2,041,212	$ 3,232,767

The table below presents the components comprising the carrying value of available-for-sale IGS reported on our consolidated balance sheets at June 30, 2007 and December 31, 2006.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 4. Real Estate Securities - (continued)

Investment-Grade Securities (AFS)

June 30, 2007 (In thousands)	Residential	Commercial	CDO	Total IGS
Current face	$ 2,276,704	$ 121,131	$ 262,881	$ 2,660,716
Unamortized discount, net	(32,187)	(3,103)	(7,096)	(42,386)
Amortized cost	2,244,517	118,028	255,785	2,618,330
Gross unrealized gains	3,800	16	640	4,456
Gross unrealized losses	(85,371)	(6,900)	(21,792)	(114,063)
Carrying value	$ 2,162,946	$ 111,144	$ 234,633	$ 2,508,723

December 31, 2006 (In thousands)	Residential	Commercial	CDO	Total IGS
Current face	$ 1,708,607	$ 122,869	$ 222,413	$ 2,053,889
Unamortized discount, net	(16,382)	(3,367)	(238)	(19,987)
Amortized cost	1,692,225	119,502	222,175	2,033,902
Gross unrealized gains	14,622	980	2,638	18,240
Gross unrealized losses	(9,597)	(869)	(464)	(10,930)
Carrying value	$ 1,697,250	$ 119,613	$ 224,349	$ 2,041,212

The table below presents the components comprising the carrying value of available-for-sale CES reported on our consolidated balance sheets at June 30, 2007 and December 31, 2006.

Credit-Enhancement Securities (AFS)

June 30, 2007 (In thousands)	Residential	Commercial	CDO	Total CES
Current face	$ 1,291,193	$ 880,987	$ 31,381	$ 2,203,561
Unamortized discount, net	(125,948)	(95,346)	(9,955)	(231,249)
Discount designated as credit reserve	(453,076)	(310,745)	—	(763,821)
Amortized cost	712,169	474,896	21,426	1,208,491
Gross unrealized gains	66,177	11,637	1,776	79,590
Gross unrealized losses	(33,371)	(35,592)	(2,069)	(71,032)
Carrying value	$ 744,975	$ 450,941	$ 21,133	$ 1,217,049

December 31, 2006 (In thousands)	Residential	Commercial	CDO	Total CES
Current face	$ 1,180,605	$ 793,743	$ 28,731	$ 2,003,079

Unamortized discount, net	(144,842)	(71,424)	(6,889)	(223,155)
Discount designated as credit reserve	(372,247)	(295,340)	—	(667,587)
Amortized cost	663,516	426,979	21,842	1,112,337
Gross unrealized gains	71,134	23,235	516	94,885
Gross unrealized losses	(13,119)	(2,154)	(394)	(15,667)
Carrying value	$ 721,531	$ 448,060	$ 21,964	$ 1,191,555

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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Note 4. Real Estate Securities - (continued)

At June 30, 2007, our residential CES provided credit-enhancement on $220 billion of residential real estate loans and our commercial CES provided credit-enhancement on $70 billion of commercial real estate loans. At December 31, 2006, our residential CES provided credit-enhancement on $210 billion of residential real estate loans and our commercial CES provided credit-enhancement on $58 billion of commercial real estate loans.

The amount of designated credit reserve equals the estimate of credit losses within the underlying loan pool on the CES that we expect to incur over the life of the loans. This estimate is determined based upon various factors affecting these assets, including economic conditions, characteristics of the underlying loans, delinquency status, past performance of similar loans, and external credit reserves. We use a variety of internal and external credit risk cash flow modeling and portfolio analytical tools to assist in our assessments. We review our assessments on each individual underlying loan pool and determine the appropriate level of credit reserve required for each security we own at least quarterly. The designated credit reserve is specific to each security.

The following table presents the aggregate changes in our unamortized discount and the portion of the discount designated as credit reserve for the three and six months ended June 30, 2007 and 2006.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

Note 4. Real Estate Securities - (continued)

Changes In Unamortized Discount and Designated Credit Reserves on Residential, Commercial, and CDO CES

Three Months Ended June 30, 2007 (In thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$ 158,669	$ 71,455	$ 7,004	$ 237,128
Amortization of discount	(21,065)	(200)	—	(21,265)
Calls, sales, and other	12,931	766	105	13,802
Re-designation between credit reserve and discount	(21,803)	9,877	—	(11,926)
Upgrades to investment-grade securities	—	—	—	—
Purchased discount (premium)	(2,784)	13,448	2,846	13,510
Ending balance of unamortized discount, net	$ 125,948	$ 95,346	$ 9,955	$ 231,249
Beginning balance of designated credit reserve	$ 392,763	$ 294,466	—	$ 687,229
Realized credit losses	(5,648)	(42)	—	(5,690)
Calls, sales, and other	(2,158)	—	—	(2,158)
Re-designation between credit reserve and discount	21,803	(9,877)	—	11,926
Purchased discount designated as credit reserve	46,316	26,198	—	72,514
Ending balance of designated credit reserve	$ 453,076	$ 310,745	—	$ 763,821

Three Months Ended June 30, 2006 (In thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$ 108,371	$ 20,473	$ 8,048	$ 136,892
Amortization of discount	(11,684)	257	—	(11,427)
Calls, sales, and other	(813)	1,835	(70)	952
Re-designation between credit reserve and discount	20,828	(884)	—	19,944
Upgrades to investment-grade securities	—	—	—	—
Purchased discount	—	6,503	—	6,503
Ending balance of unamortized discount, net	$ 116,702	$ 28,184	$ 7,978	$ 152,864

Beginning balance of designated credit reserve	$	373,781	$	167,772	—$	541,553
Realized credit losses		(1,041)		138	—	(903)
Calls, sales, and other		(192)		—	—	(192)
Re-designation between credit reserve and discount		(20,828)		884	—	(19,944)
Purchased discount designated as credit reserve		73,858		23,340	—	97,198
Ending balance of designated credit reserve	$	425,578	$	192,134	—$	617,712

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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(Unaudited)

Note 4. Real Estate Securities - (continued)

Changes In Unamortized Discount and Designated Credit Reserves on Residential, Commercial, and CDO CES

Six Months Ended June 30, 2007 (In thousands)	**Residential**	**Commercial**	**CDO**	**Total**
Beginning balance of unamortized discount, net	$ 144,842	$ 71,424	$ 6,889	$ 223,155
Amortization of discount	(39,957)	(191)	—	(40,148)
Calls, sales, and other	15,301	766	105	16,172
Re-designation between credit reserve and discount	509	9,480	—	9,989
Upgrades to investment-grade securities	—	160	115	275
Purchased discount	5,253	13,707	2,846	21,806
Ending balance of unamortized discount, net	$ 125,948	$ 95,346	$ 9,955	$ 231,249
Beginning balance of designated credit reserve	$ 372,247	$ 295,340	—	$ 667,587
Realized credit losses	(9,453)	(1,313)	—	(10,766)
Calls, sales, and other	(3,674)	—	—	(3,674)
Re-designation between credit reserve and discount	(509)	(9,480)	—	(9,989)
Purchased discount designated as credit reserve	94,465	26,198	—	120,663
Ending balance of designated credit reserve	$ 453,076	$ 310,745	—	$ 763,821

Six Months Ended June 30, 2006 (In thousands)	**Residential**	**Commercial**	**CDO**	**Total**
Beginning balance of unamortized discount, net	$ 121,824	$ 28,993	$ 8,004	$ 158,821
Amortization of discount	(24,075)	821	—	(23,254)
Calls, sales, and other	(57)	1,209	(26)	1,126
Re-designation between credit reserve and discount	22,650	(5,313)	—	17,337
Upgrades to investment-grade securities	(6,249)	—	—	(6,249)
Purchased discount	2,609	2,474	—	5,083
Ending balance of unamortized discount, net	$ 116,702	$ 28,184	$ 7,978	$ 152,864

Beginning balance of designated credit reserve	$ 354,610	$ 141,806	—$	496,416
Realized credit losses	(3,618)	136	—	(3,482)
Calls, sales, and other	(4,903)	—	—	(4,903)
Re-designation between credit reserve and discount	(22,650)	5,313	—	(17,337)
Purchased discount designated as credit reserve	102,139	44,879	—	147,018
Ending balance of designated credit reserve	$ 425,578	$ 192,134	—$	617,712

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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(Unaudited)

Note 4. Real Estate Securities - (continued)

For the three and six months ended June 30, 2007, we recognized other-than-temporary impairments of $21.7 million and $24.1 million, respectively, through market valuation adjustments in our consolidated statements of income. This includes AFS securities that were in unrealized loss positions of $2.4 million at the end of the period that we did not deem the cash flows impaired but we did not intend to hold for a period long enough to recover the unrealized loss. For the three and six months ended June 30, 2006, we recognized other-than-temporary impairments of $2.3 million and $5.5 million, respectively.

The table below presents the gross realized gains and losses on securities and the realized gains on calls for the three and six months ended June 30, 2007 and 2006.

Gross Realized Gains and Losses on Real Estate Securities

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	**2007**	**2006**	**2007**	**2006**
Gross realized gains on sales	$ 2,746	$ 3,389	$ 3,415	$ 4,451
Gross realized losses on sales	(1,284)	(1,348)	(2,737)	(1,348)
Gains on calls	1,310	747	2,153	747
Total realized gains on sales and calls	$ 2,772	$ 2,788	$ 2,831	$ 3,850

Gross unrealized gains and losses represent the difference between the net amortized cost and the fair market value of individual securities. Gross unrealized losses represent a decline in fair market value for securities not deemed impaired for GAAP.

The following tables show the gross unrealized losses, fair market values, and length of time that any real estate securities have been in a continuous unrealized loss position as of June 30, 2007 and December 31, 2006. These unrealized losses are not considered to be other-than-temporary impairments because these losses are not due to adverse changes in cash flows and we have the intent and ability to hold these securities for a period sufficient for these securities to potentially recover their values.

Securities with Unrealized Losses

	Less Than 12 Months		12 Months or More		Total	
June 30, 2007 (In thousands)	**Fair Market Value**	**Unrealized Losses**	**Fair Market Value**	**Unrealized Losses**	**Fair Market Value**	**Unrealized Losses**
Residential	$ 1,792,503	$ (99,977)	$ 322,159	$ (18,765)	$ 2,114,662	$ (118,742)
Commercial	363,950	(34,326)	108,054	(8,166)	472,004	(42,492)
CDO	188,480	(20,475)	16,794	(3,386)	205,274	(23,861)
Total securities	$ 2,344,933	$ (154,778)	$ 447,007	$ (30,317)	$ 2,791,940	$ (185,095)

December 31, 2006 (In thousands)	Less Than 12 Months Fair Market Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Market Value	12 Months or More Unrealized Losses	Total Fair Market Value	Total Unrealized Losses
Residential	$ 495,242	$ (9,938)	$ 385,170	$ (12,778)	$ 880,412	$ (22,716)
Commercial	111,603	(1,055)	85,010	(1,968)	196,613	(3,023)
CDO	29,378	(257)	29,543	(601)	58,921	(858)
Total securities	$ 636,223	$ (11,250)	$ 499,723	$ (15,347)	$ 1,135,946	$ (26,597)

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Note 4. Real Estate Securities - (continued)

We fund the credit-sensitive securities we acquire with equity. We fund some of the securities we acquire on a temporary basis with short-term borrowings prior to the sale to the securitization entities we sponsor. We also acquire less credit-risk sensitive assets and finance these investments with a combination of Redwood debt and equity. The table below presents information regarding our securities pledged under borrowing agreements and owned by securitization entities as of June 30, 2007 and December 31, 2006.

Securities Pledged and Unpledged

(In thousands)		June 30, 2007		December 31, 2006
Unpledged	$	539,963	$	463,891
Pledged for Redwood debt		133,333		593,070
Owned by securitization entities, financed through issuance of ABS		3,052,476		2,175,806
Carrying value	$	3,725,772	$	3,232,767

Note 5. Other Real Estate Investments

Other real estate investments shown on our balance sheets include IOs, NIMs and residuals. We have elected to classify these investments as “trading investments” under GAAP. These assets are carried at fair market value on our consolidated balance sheet and changes in fair market value flow through market valuation adjustments, net on the consolidated statements of income.

The table below presents the carrying value (which equals fair market value as these are classified as trading instruments) of these investments as of June 30, 2007. We did not have any assets classified as other real estate investments at December 31, 2006.

Other Real Estate Investments - Trading

June 30, 2007 (In thousands)		Prime		Alt-a		Subprime		Total
Residential								
IOs	$	1,453	$	351	$	—	$	1,804
NIMs		—		9,084		13,086		22,170
Residuals		—		7,764		2,430		10,194
Total other real estate investments	$	1,453	$	17,199	$	15,516	$	34,168

The fair market value of our other real estate investments declined $6.2 million and $11.6 million for the three and six months ended June 30, 2007 respectively. As of June 30, 2007, $2.0 million of other real estate investments were owned by securitization entities, financed through the issuance of ABS. The remaining $32.2 million were funded with equity.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 6. Non-Real Estate Investments

Non-real estate investments represents an $80 million guaranteed investment contract (GIC) entered into during the second quarter of 2007 by an Acacia securitization entity that we consolidate for financial statements purposes. This GIC represents a deposit certificate issued by a rated investment bank. This deposit certificate earns LIBOR minus a spread. This GIC serves as the collateral to cover potential losses on a credit default swap (CDS) also entered into by this same Acacia entity. The CDS references BBB and A rated residential mortgage-backed securities issued in 2006. In the event that any of these referenced securities incurs a credit loss, the GIC can then be drawn upon by the CDS counterparty to cover the amount of such loss. We have classified this investment as a trading security that is recorded on our consolidated balance sheets at its estimated fair market value. Management currently considers the GIC's fair market value to approximate contract value, as the interest rate is variable at LIBOR less 5 basis points and resets on a monthly basis. Changes in fair market value are reported through our consolidated statements of income through market valuation adjustments.

The carrying and fair market value was $80 million of this investment as of June 30, 2007. We did not have any assets classified as non-real estate investments in prior periods.

Note 7. Derivative Financial Instruments

We report our derivative financial instruments at fair market value as determined using third-party models and confirmed by Wall Street dealers. As of June 30, 2007 and December 31, 2006, the net fair market value of derivative financial instruments was $34.5 million and $20.6 million, respectively.

The following table shows the aggregate fair market value and notional amount of our derivative financial instruments as of June 30, 2007 and December 31, 2006.

(In thousands)	**June 30, 2007**		**December 31, 2006**	
	Fair Market Value	**Notional Amount**	**Fair Market Value**	**Notional Amount**
Trading Instruments				
Interest rate caps purchased	$ 4,432	$ 701,900	$ 1,114	$ 71,900
Interest rate caps sold	(985)	250,000	—	—
Interest rate corridors purchased	—	755,616	—	844,805
Interest rate swaps	(453)	354,513	242	131,195
Credit default swaps	(3,939)	78,000	(6)	1,000
Futures	—	—	90	204,000
Purchase commitments	67	148,531	(168)	80,964
Cash Flow Hedges				
Futures	—	—	(44)	627,000
Interest rate swaps	35,341	1,300,965	19,385	1,279,007
Total Derivative Financial Instruments	$ 34,463	$ 3,589,525	$ 20,613	$ 3,239,871

Interest Rate Agreements

We maintain an overall interest rate risk management strategy that incorporates the use of interest rate agreements for a variety of reasons, including minimizing significant fluctuations in earnings or market values on certain assets or liabilities that may be caused by interest rate volatility. Currently, the majority of our interest rate agreements are used to match the duration of liabilities to assets. Interest rate agreements we use as part of our interest rate risk management strategy may include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchases. We currently account for our interest rate agreements as either cash flow hedges or trading instruments.

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Note 7. Derivative Financial Instruments - (continued)

In a cash flow hedge, the effective portion of the change in the fair market value of the hedging derivative is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings when the hedging relationship is terminated. The ineffective portion of the cash flow hedge is recognized immediately in earnings. For the three and six months ended June 30, 2007, the amount of ineffectiveness was $0.7 million income and $0.6 million income, respectively, and was $0.4 million of expense and $0.1 million of income for the three and six months ended June 30, 2006, respectively.

Interest rate agreements accounted for as cash flow hedges may be terminated prior to the completion of the forecasted transactions. In these cases, and when the forecasted transaction is still likely to occur, the net gain or loss on the interest rate agreements remains in accumulated other comprehensive income and will be reclassified from accumulated other comprehensive income to our consolidated statements of income during the period the forecasted transaction occurs.

Our total unrealized gain on interest rate agreements included in accumulated other comprehensive income was $20.3 million at June 30, 2007 and $7.0 million at December 31, 2006.

We reclassified a negligible and negative $6,000 from other comprehensive income to interest expense for the three and six months ended June 30, 2007, respectively, and reclassified positive $0.2 million and positive $0.5 million for the three and six months ended June 30, 2006, respectively. At June 30, 2007, the maximum length of time over which we are hedging our exposure to the variability of future cash flows for forecasted transactions with cash flow hedges is ten years, and in all cases, the forecasted transactions are expected to occur within the next year.

In the case when the hedge is terminated and the forecasted transaction is not expected to occur, we immediately recognize the gain or loss through gains on sales, net in our consolidated statements of income. For the three months ended June 30, 2007, there were no such instances. For the six months ended June 30, 2007, there was one such instance which resulted in a gain of $1 million. For the three and six months ended June 30, 2006, there was one such instance which resulted in a gain of $6 million.

Our interest rate agreements had net receipts of $2.7 million and $5.1 million for the three and six months ended June 30, 2007, respectively, and net receipts of $3.8 million and $6.1 million for the three and six months ended June 30, 2006, respectively.

The following table presents the interest income and expense of our interest rate agreements accounted for as cash flow hedges for the three and six months ended June 30, 2007 and 2006.

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Note 7. Derivative Financial Instruments - (continued)

Impact on Interest Income (Expense) of Our Interest Rate Agreements Accounted for as Cash Flow Hedges

(In thousands)	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Net interest income on cash flow interest rate agreements	$ 2,693	$ 3,823	$ 5,092	$ 6,054
Realized net gains (losses) due to net ineffective portion of hedges	671	(350)	590	133
Realized net (losses) gains reclassified from other comprehensive income	(6)	206	(678)	472
Total	$ 3,358	$ 3,679	$ 5,004	$ 6,659

When the interest rate agreement is accounted for as a trading instrument, changes in the fair market value of the interest rate agreement and all associated income and expenses are reported in earnings through net recognized valuation adjustments. We had net valuation adjustments on interest rate agreements of negative $1.5 million and negative $3.0 million for three and six months ended June 30, 2007, respectively, and positive $5.5 million and positive $5.8 million for the three and six months ended June 30, 2006.

Purchase Commitments

Our loan purchase commitments represent derivative instruments under FAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149.) At June 30, 2007, our commitments to purchase residential real estate loans were $149 million, and had a fair market value of less than $0.1 million. The change in fair market value from period to period is included in valuation adjustments, in our consolidated statements of income.

Credit Default Swaps

A credit default swap is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed rate fee or premium over the term of the contract. In the first quarter of 2007, we began entering into these agreements where we agreed to provide credit event protection in exchange for a premium. In essence, these instruments enables us to credit enhance a specific pool of loans. We included these credit default swaps in our Acacia CDO Option Arm 1 which closed in the second quarter of 2007.

Credit default swaps are accounted for as trading instruments, reported at fair market value with the changes in fair market value recognized through our income statement. The value of these contracts decrease for a variety of reasons, including when the probability of the occurrence of a specific credit event increases, when the market’s perceptions of default risk in general change, or there are changes in the supply and demand of these instruments. Since the acquisition of these credit default swaps, the value has decreased $3.9 million, primarily as the result of widening spreads in these types of instruments.

During the second quarter of 2007, we also entered into a credit default swap where we agreed to pay a premium and will receive payment upon the event of losses on the referenced pool of loans. At June 30, 2007, this derivative instrument had a negative market value of $0.1 million.

In the future, we may use credit default swaps to help us manage certain of our credit risks. We would do this by agreeing to pay a fixed rate or premium in exchange for credit event protection.

Counterparty Credit Risk

We incur credit risk to the extent that the counterparties to the derivative financial instruments do not perform their obligations under the agreements. If one of the counterparties does not perform, we may not receive the cash to which we would otherwise be entitled under the agreement. In order to mitigate this risk, we only enter into agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the U.S. Department of Treasury as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated BBB or higher. Furthermore, we generally enter into agreements with several different counterparties in order to diversify our credit risk exposure. At June 30, 2007, we had $1.0 million credit exposure in interest rate agreements. At December 31, 2006, we had $1.0 million credit exposure on futures and $5.1 million credit exposure on interest rate agreements.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 8. Reserves for Credit Losses

We establish reserves for credit losses on our real estate loans based on our estimate of losses inherent in our loan portfolio.

Delinquencies in our consolidated residential real estate loan portfolio were $56 million and $65 million as of June 30, 2007 and December 31, 2006, respectively. Delinquencies include loans delinquent more than 90 days, in bankruptcy, and in foreclosure. As a percentage of our current residential real estate loan balances, delinquencies stood at 0.67% and 0.71% at June 30, 2007 and December 31, 2006, respectively. As a percentage of the original balances, delinquencies stood at 0.20% and 0.21% at June 30, 2007 and December 31, 2006, respectively.

Our residential loan servicers advance payment on delinquent loans to the extent they deem them recoverable. We accrue interest on loans until they are more than 90 days past due at which point they are placed on nonaccrual status. When a loan becomes REO, we estimate the specific loss, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest) and charge this specific estimated loss against the reserve for credit losses.

For the three months ended June 30, 2007, we had a total provision of $2.5 million. At the end of the second quarter of 2007 we transferred $13 million (of principal value) of delinquent residential loans from held for investment to held for sale at the lower of cost or fair market value (LOCOM) with a corresponding reduction in the reserve for credit losses through charge-offs. The impact was a $4 million reduction of the balance sheet credit reserve.

The following table summarizes the activity in reserves for credit losses for our consolidated residential real estate loans for the three and six months ended June 30, 2007 and 2006.

Residential Real Estate Loan Reserves for Credit Losses

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	**2007**	**2006**	**2007**	**2006**
Balance at beginning of period	$ 19,954	$ 22,372	$ 20,119	$ 22,656
Provision for credit losses	2,500	(2,541)	3,981	(2,365)
Charge-offs	(6,038)	(381)	(7,684)	(841)
Balance at end of period	$ 16,416	$ 19,450	$ 16,416	$ 19,450

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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Note 8. Reserves for Credit Losses - (continued)

The following table summarizes the activity in reserves for credit losses for our commercial real estate loans for the three and six months ended June 30, 2007 and 2006.

Commercial Real Estate Loan Reserves for Credit Losses

(In thousands)	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Balance at beginning of period	$ 2,348	$ —	$ —	$ —
Provision for credit losses	—	35	2,348	35
Charge-offs	—	(35)	—	(35)
Balance at end of period	$ 2,348	$ —	$ 2,348	$ —

During the first quarter of 2007, we fully reserved in the amount of $2.3 million for an anticipated loss on a junior mezzanine commercial loan financing a condominium-conversion project. Principal and accrued interest on this loan was scheduled to be paid upon the completion of the project and sale of the units. Accordingly, the loan was not delinquent. However, due to cost overruns and changing market conditions, we believe it is unlikely we will collect any outstanding principal upon completion of the project. The provision for credit losses on commercial loans for the six months ended June 30, 2007 relates to that loan.

Note 9. Other Assets

Other assets as of June 30, 2007 and December 31, 2006 are summarized in the following table.

Other Assets

(In thousands)	June 30, 2007	December 31, 2006
Real estate owned (REO)	$ 9,686	$ 7,963
Fixed assets and leasehold improvements	7,217	4,439
Principal receivable	3,889	4,417
Purchased interest	754	1,045
Other	1,823	2,342
Total other assets	$ 23,369	$ 20,206

Note 10. Redwood Debt

We enter into repurchase agreements, bank borrowings, and other forms of collateralized (and generally uncommitted) borrowings with several banks and major investment banking firms. We also issue commercial paper for financing residential and commercial real estate loans and securities. We refer to these borrowings as Redwood debt. We report Redwood debt at its unpaid principal balance. We also have other types of recourse debt such as subordinated notes (See *Note 12*). The table below summarizes the outstanding balances of Redwood debt as of June 30, 2007 and December 31, 2006, by collateral type.

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Note 10. Redwood Debt - (continued)

Redwood Debt

	June 30, 2007			
(In thousands)	**Number of Facilities**	**Outstanding**	**Limit**	**Maturity**
Facilities by collateral				
Real estate loans	4	$ 496,794	$ 2,350,000	8/07-1/08
Real estate securities	11	161,148	4,287,000	—
Unsecured line of credit	1	—	10,000	10/07
Madrona commercial paper facility	1	190,720	490,000	7/09
Total facilities	17	$ 848,662	$ 7,137,000	

	December 31, 2006			
(In thousands)	**Number of Facilities**	**Outstanding**	**Limit**	**Maturity**
Facilities by collateral				
Real estate loans	5	$ 959,139	$ 2,700,000	1/07-10/07
Real estate securities	14	597,069	5,787,000	—
Unsecured line of credit	1	—	10,000	10/07
Madrona commercial paper facility	1	300,000	490,000	7/09
Total facilities	21	$ 1,856,208	$ 8,987,000	

At June 30, 2007, we had $4.3 billion of uncommitted real estate securities facilities and $2.4 billion of uncommitted real estate loan facilities included within the limits above.

At June 30, 2007, Redwood debt was all short-term debt. Borrowings under these facilities generally bear interest based on a specified margin over the one-month LIBOR interest rate. For the three and six months ended June 30, 2007, the average balance of Redwood debt was $1.5 billion and $1.9 billion, respectively, with a weighted-average interest cost of 5.99% and 5.82%, respectively. For the three and six months ended June 30, 2006, the average balance of Redwood debt was $0.1 billion, with a weighted-average interest cost of 8.51% and 7.00%, respectively. At June 30, 2007 and December 31, 2006, accrued interest payable on Redwood debt was $0.7 million and $7.0 million, respectively.

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Note 10. Redwood Debt - (continued)

As of June 30, 2007 and December 31, 2006, we had $191 million and $300 million of commercial paper outstanding through our Madrona special purpose entity, respectively. The table below summarizes Redwood debt by weighted average interest rates and by collateral type in Redwood debt at June 30, 2007 and December 31, 2006.

Redwood Debt

	June 30, 2007			December 31, 2006		
(In thousands)	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
Real estate loan collateral	$ 687,514	5.64%	13	$ 1,259,139	5.54%	21
Securities collateral	161,148	5.36%	26	597,069	6.06%	110
Total Redwood debt	$ 848,662	5.59%	16	$ 1,856,208	5.71%	49

The following table presents the remaining maturities of Redwood debt as of June 30, 2007 and December 31, 2006.

Redwood Debt

(In thousands)	June 30, 2007	December 31, 2006
Within 30 days	$ 848,662	$ 1,259,138
31 to 90 days	—	392,566
Over 90 days	—	204,504
Total Redwood debt	$ 848,662	$ 1,856,208

We continue to be in compliance with all of our debt covenants for all of our borrowing arrangements and credit facilities. Additional collateral in the form of additional qualifying assets or cash may be required to meet changes in fair market values from time to time under these agreements. Covenants associated with our debt generally relate to our tangible net worth, liquidity reserves, and leverage requirements. We have not had, nor do we currently anticipate having, any problems in meeting these covenants. It is our intention to renew committed and uncommitted facilities as needed, as well as pursue additional facilities and other types of financing.

Note 11. Asset-Backed Securities Issued

The Sequoia and Acacia securitization entities sponsored by us issue ABS to raise the funds to acquire assets from us and others. Each series of ABS consists of various classes that pay interest at variable and fixed rates. Substantially all of the variable-rate ABS are indexed to one-, three- or six-month LIBOR, with interest paid monthly or quarterly. A lesser amount of the ABS is fixed for a term and then will adjust to a LIBOR rate (hybrid ABS) or is fixed for its entire term. Some of the ABS securities issued are IOs and have coupons set at a fixed rate or a fixed spread, while others earn a coupon based on the spread between collateral owned by and the ABS issued by a securitized entity.

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Note 11. Asset-Backed Securities Issued - (continued)

The maturity of each class of ABS is directly affected by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of an ABS is likely to occur earlier than its stated maturity.

The carrying value components of the collateral for ABS issued and outstanding as of June 30, 2007 and December 31, 2006 are summarized in the table below.

Collateral for Asset-Backed Securities Issued

(In thousands)	June 30, 2007	December 31, 2006
Real estate loans	$ 7,499,974	$ 7,955,632
Real estate securities	3,052,476	2,175,806
Other real estate investments	1,964	—
Real estate owned (REO)	6,946	7,963
Restricted cash owned by consolidated securitization entities	206,664	111,124
Accrued interest receivable		