

REDWOOD TRUST INC
Form 10-K
February 26, 2014
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UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended: December 31, 2013

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 **68-0329422**
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)
One Belvedere Place, Suite 300
Mill Valley, California 94941
(Address of Principal Executive Offices) (Zip Code)
(415) 389-7373
(Registrant's Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(b) 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 if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark whether the registrant is 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. (Check one):

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

At June 30, 2013, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$1,385,595,030 based on the closing sale price as reported on the New York Stock Exchange.

The number of shares of the registrant's Common Stock outstanding on February 21, 2014 was 82,534,625.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement to be filed with the Securities and Exchange Commission under Regulation 14A within 120 days after the end of registrant's fiscal year covered by this Annual Report are incorporated by reference into Part III.

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PART I

ITEM 1. BUSINESS

Introduction

Redwood Trust, Inc., together with its subsidiaries, is an internally-managed specialty finance company focused on engaging in residential and commercial mortgage banking activities and investing in mortgage- and other real estate-related assets. 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 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 income from our mortgage banking activities. Net interest income consists of the interest income we earn less the interest expenses 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.

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 operating 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 operating 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.

Financial information concerning our business, both on a consolidated basis and with respect to each of our segments, is set forth in our consolidated financial statements and notes thereto included in this Annual Report on Form 10-K as well as in Management's Discussion and Analysis of Financial Condition and Results of Operations and the supplemental financial information, which are included in Part II, Items 7 and 8 of this Annual Report on Form 10-K.

Our Operating Business Segments

Our residential mortgage banking segment primarily consists of operating a mortgage loan platform. This platform is engaged in the business of acquiring residential loans from third-party originators and then selling, financing, or securitizing those loans with the intent of profiting from these activities. 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. Loans we acquire that conform to the eligibility criteria of Fannie Mae and Freddie Mac are generally sold to these entities. Our residential loan acquisitions are usually made on a loan-by-loan, or 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 our capital and short-term debt. This segment also includes various derivative financial instruments and interest-only (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 expenses 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 mortgage servicing rights (MSR) associated with residential loans securitized through our Sequoia program and MSRs purchased from third parties. The owner of an MSR is entitled to receive a portion of the interest payments from the associated residential loan and is obligated to directly service, or retain a sub-servicer to directly service, the associated loan. Residential loans for which we own

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the MSR are directly serviced by a licensed sub-servicer we retain, as we do not originate or directly service any residential loans. Our 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. Also included in this segment is interest expense on the short-term debt and asset-backed securities 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 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 debt used to fund the purchase of commercial loans as well as operating expenses and the tax provisions associated with these activities are also included in the commercial mortgage banking segment.

Sponsored, Managed, and Consolidated Entities

Throughout our history we have sponsored or managed other investment entities, including a private limited partnership fund that we managed, the Redwood Opportunity Fund, LP (the Fund), as well as Acacia securitization entities, certain of which we continue to manage. The Fund was primarily invested in residential securities and the Acacia entities are primarily invested in a variety of real estate-related assets. We are not currently seeking to sponsor or manage other entities like the Fund or the Acacia securitization 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.

Many of the entities we have sponsored or managed are currently, or have been historically, recorded on our consolidated balance sheets for financial reporting purposes based upon applicable accounting guidance set forth by Generally Accepted Accounting Principles in the United States (GAAP). However, each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not, respectively, owned by us or legal obligations of ours, 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.

Information Available on Our Website

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 Corporate 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 link on our website, we also disclose information about our recent originations and acquisitions of commercial loans and other commercial investments. 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 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 Annual Report on Form 10-K.

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

Cautionary Statement

This Annual Report on Form 10-K 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 by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in this Annual Report on Form 10-K under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are described below and 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 future 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 outlook for our residential business, investing in prime mortgage credit risk and our positioning to pursue investments in conforming credit through potential risk-sharing arrangements (recourse and other types) with the GSEs; (iii) our belief that triple-A investors will return to the private label securitization market for prime quality loans when improved securitization structures and issuer best practices become more widely adopted by participants, and our expectation that subordination levels will decline over time, reflecting the performance of the underlying collateral, and that this will improve the economics for issuers such as Redwood; (iv) statements we make regarding GSE reform legislation, including that the private sector will become the provider of first-loss credit risk, ahead of a government guarantee, and the opportunity this presents for private credit risk investors with loan acquisition platforms, such as Redwood; (v) our expectations regarding our loan sale distribution via whole loan sales and securitizations, our expectation to complete a securitization late in the first quarter or early in the second quarter of 2014 and our outlook for residential loan sale profit margins, including our statement that we believe we can generate attractive loan sale profit margins within our long-term target range of 25 to 50 basis points; (vi) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase, including the amount of such loans that we identified for purchase at December 31, 2013; (vii) statements relating to our expectation to increase the number of sellers we acquire loans from; (viii) statements relating to the volume of jumbo and conforming residential mortgage loans expected to be available for purchase during 2014, including that we expect the decline in our jumbo loan acquisition volume from 2013 to be less than the decline projected for the industry as a whole, and our goal to ramp up to a run rate of \$1 billion per month of conforming loan acquisitions by the end of 2014; (ix) our outlook and expectations relating to our commercial real estate platform, including statements regarding our expectations regarding improvement in underlying commercial real estate fundamentals and potential refinancing opportunities for lenders with established commercial loan origination platforms such as Redwood, and our plans to expand our commercial platform in 2014 by adding originators, (x) our expectations regarding the volume of senior and mezzanine commercial loans that we will originate in 2014, and our expectation that the amount of capital we had previously allocated to fund commercial mortgage banking and investment activities should remain adequate for us to continue

growing this platform, and statements relating to the possibility of raising dedicated capital for our commercial platform; (xi) statements relating to our estimate of our investment capacity (including that we estimate our investment capacity at December 31, 2013 to be approximately \$130 million) and our statement that we believe this level of investment capacity and liquidity should be sufficient to fund our business and investment objectives for most or all of 2014; and (xii) 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 \$59 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

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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 Annual Report on Form 10-K 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.

Certifications

Our Chief Executive Officer and Chief Financial Officer have executed certifications dated February 25, 2014, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, and we have included those certifications as exhibits to this Annual Report on Form 10-K. In addition, our Chief Executive Officer certified to the New York Stock Exchange (NYSE) on May 28, 2013 that he was unaware of any violations by Redwood Trust, Inc. of the NYSE's corporate governance listing standards in effect as of that date.

Employees

As of December 31, 2013, Redwood employed 141 people.

ITEM 1A. RISK FACTORS

General economic developments and trends and the performance of the housing, commercial real estate, mortgage finance, and broader financial markets may adversely affect our business and the value of, and returns on, real estate-related and other assets we own or may acquire and could also negatively impact our business and financial results.

Our level of business activity and the profitability of our business, as well as the values of, and the cash flows from, the assets we own, are affected by developments in the U.S. economy. As a result, negative economic developments are likely to negatively impact our business and financial results. There are a number of factors that could contribute to negative economic developments, including, but not limited to, high unemployment, rising government debt levels, U.S. fiscal and monetary policy changes, including Federal Reserve policy shifts, changing U.S. consumer spending

patterns, negative developments in the housing and commercial real estate markets, and changing expectations for inflation and deflation. Personal income and unemployment levels affect borrowers' ability to repay residential mortgage loans underlying residential real estate-related assets we own, and there is risk that economic growth and activity could be weaker than anticipated or negative.

The economic downturn that began in 2007 and the significant government interventions into the financial markets and fiscal stimulus spending that occurred in subsequent years have contributed to significantly increased U.S. budget deficits and overall debt levels. These increases have put upward pressure on interest rates and could be among the factors that could lead to higher interest rates over the long-term future. Higher long-term interest rates could adversely affect our overall business, income, and our ability to pay dividends, as discussed further below under *Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and increased volatility in our earnings*. Furthermore, our business and financial results may be harmed by our inability to accurately anticipate developments associated with changes in, or the outlook for, interest rates. In addition, near-term and long-term U.S. economic conditions are likely to be impacted by the ability of Congress and the President to effectively address policy differences regarding the U.S. federal budget, budget deficit, and debt level.

Real estate values, and the ability to generate returns by owning or taking credit risk on loans secured by real estate, are important to our business. Over the last several years, government intervention has been important to support real estate markets, the overall U.S. economy, capital markets, and mortgage markets. We expect the government will continue to gradually withdraw this support, although we remain uncertain about the extent, timing, process, and implications of any withdrawal. Mortgage markets have also received substantial U.S. government support. In particular, the government's support of mortgage markets through its support of

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Fannie Mae and Freddie Mac expanded in late 2008, as the U.S. Treasury Department chose to backstop these government-sponsored enterprises. The governmental support for these entities has contributed to Fannie Mae's and Freddie Mac's continued dominance of residential mortgage finance and securitization activity, inhibiting the return of private mortgage securitization. This support may continue for some time and could have potentially negative consequences to us, since we have traditionally taken an active role in assuming credit risk in the private sector mortgage market, including through investments in Sequoia securitizations we sponsor.

Developments relating to the fixed income and mortgage finance markets and the Federal Reserve's statements regarding its future open market activity and monetary policy could adversely affect our future business and financial results and the value of, and returns on, real estate-related investments and other assets we own or may acquire.

During 2013 and to date in 2014, statements made by the Chair and other members of the Board of Governors of the Federal Reserve System and by other Federal Reserve Bank officials regarding the U.S. economy, future economic growth, and the Federal Reserve's future open market activity (and the so-called "tapering" of certain of that activity relating to the acquisition of Treasury securities and mortgage-backed securities (MBS)) and monetary policy have had a significant impact on, among other things, benchmark interest rates, the value of residential mortgage loans, and, more generally, the fixed income markets. These statements, the actions of the Federal Reserve, and other factors also significantly impacted many market participants' expectations and outlooks regarding future levels of benchmark interest rates and the expected yields these market participants would require to invest in fixed income instruments, including most residential mortgages and residential mortgage-backed securities (RMBS).

One of the immediate potential impacts of rising benchmark interest rates on our business would be a reduction in the overall value of the pool of residential mortgage loans that we own and the overall value of the pipeline of residential mortgage loans that we have identified for purchase. Rising benchmark interest rates also generally have a negative impact on the overall cost of short-term borrowings we use to finance our acquisitions and holdings of residential mortgage loans, including as a result of the requirement to post additional margin (or collateral) to lenders to offset any associated decline in value of the mortgage loans we finance with short-term borrowings. The short-term borrowings we use to finance our acquisitions and holdings of residential mortgage loans are uncommitted and have a limited term, which could result in these types of borrowings not being available in the future to fund our acquisitions and holdings and could result in our being required to sell holdings of residential mortgage loans and incur losses. Similar impacts would also be expected with respect to the short-term borrowings we use to finance our acquisitions and holdings of RMBS. In addition, any inability to fund acquisitions of mortgage loans could damage our reputation as a reliable counterparty in the mortgage finance markets.

Rising benchmark interest rates have also impacted, and are likely to continue to impact, the volume of residential mortgage loans available for purchase in the marketplace and our ability to compete to acquire residential mortgage loans as part of our residential mortgage banking activities. These impacts could result from, among other things, a lower overall volume of mortgage refinance activity by mortgage borrowers and an increased level of competition from large commercial banks that may operate with a lower cost of capital than we do, including as a result of Federal Reserve monetary policies that impact banks more favorably than us and other non-bank institutions. These and other impacts of developments of the type described above have had, and may continue to have, a negative impact on our business and results of operations and we cannot accurately predict the full extent of these impacts or for how long they may persist.

Federal and state legislative and regulatory developments and the actions of governmental authorities and entities may adversely affect our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future.

As noted above, our business is affected by conditions in the residential and commercial real estate markets and the broader financial markets, as well as by the financial condition and resources of other participants in these markets. These markets and many of the participants in these markets are subject to, or regulated under, various federal and state laws and regulations. In some cases, the government or government-sponsored entities, such as Fannie Mae and Freddie Mac, directly participate in these markets. In particular, because issues relating to residential real estate and housing finance can be areas of political focus, federal, state and local governments may be more likely to take actions that affect residential real estate, the markets for financing residential real estate, and the participants in residential real estate-related industries than they would with respect to other industries. As a result of the government's statutory and regulatory oversight of the markets we participate in and the government's direct and indirect participation in these markets, federal and state governmental actions, policies, and directives can have an adverse effect on these markets and on our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future, which effects may be material.

As an example, based on published data, we believe that through financing or guarantees Fannie Mae, Freddie Mac, the Federal Housing Administration, and other governmental agencies accounted for more than 85% of the financing for new residential mortgage loans in 2009, 2010, 2011, 2012 and the first nine months of 2013. As a result, most of the market for housing finance in the U.S. is effectively controlled by the federal government and can be materially affected by decisions of federal policy makers, the President,

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and Congress. In addition, the Federal Reserve has taken certain actions (e.g., implementing a program to acquire, and now tapering the pace of acquiring, Treasury securities and MBS) and may take other actions that could have significant implications for mortgage-related securities pricing and the returns we expect on our mortgage-related assets. Financial regulators globally are coordinating the implementation of capital regulations under the Basel III accord in an attempt to better coordinate and set capital standards for certain types of regulated financial institutions and appropriately account for risk, which may also have indirect impacts on our business and financial results.

If the federal government determines to maintain or expand its current role in the markets for financing residential mortgage loans, it may adversely affect our business or our ability to effectively compete. Even if the federal government determines to decrease its role in the markets for financing residential mortgage loans, it may establish regulations for other market participants that have an adverse effect on our ability to effectively participate or compete or which may diminish or eliminate the returns on mortgages, mortgage-related securities, and other assets we own or may acquire in the future.

Changes to income tax laws and regulations, or other tax laws or regulations, which may be enacted at the federal or state level, could also negatively impact residential and commercial real estate markets, mortgage finance markets, and our business and financial results. For example, an elimination or reduction in the current personal income tax deduction for interest payments on residential mortgage debt, which is one of the mechanisms that lawmakers have discussed in connection with resolving the U.S. federal budget deficit, could negatively impact real estate values, our business, and our financial results.

Furthermore, the credit crisis and subsequent financial turmoil prompted the federal government to put into place new statutory and regulatory frameworks and policies for reforming the U.S. financial system. These financial reforms are aimed at, among other things, promoting robust supervision and regulation of financial firms, establishing comprehensive supervision of financial markets, protecting consumers and investors from financial abuse, providing the U.S. government with additional tools to manage financial crises, and raising international regulatory standards and improving international cooperation, but their scope could be expanded beyond what has been currently enacted, implemented, and proposed. Certain financial reforms focused specifically on the issuance of asset-backed securities through securitization transactions have not been fully implemented, but are expected to include significantly enhanced disclosure requirements, risk retention requirements, and rules restricting a broad range of conflicts of interests in regard to these transactions. Implementation of financial reforms, whether through law, regulations, or policy, including changes to the manner in which financial institutions, financial products, and financial markets operate and are regulated and any related changes in the accounting standards that govern them, could adversely affect our business and financial results by subjecting us to regulatory oversight, making it more expensive to conduct our business, reducing or eliminating any competitive advantage we may have, or limiting our ability to expand, or could have other adverse effects on us.

During and since 2008, the federal government has also made available programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures, including through loan modification and refinancing programs. In addition, certain mortgage lenders and servicers have voluntarily, or as part of settlements with law enforcement authorities, established loan modification programs relating to the mortgages they hold or service and adopted new servicing standards intended to protect homeowners. Changes to servicing standards, whether resulting from a settlement or a change in regulation, are likely to have the effect of lengthening the time it takes for a servicer to foreclose on the property underlying a delinquent mortgage loan. Loan modification programs and changes to servicing standards and regulations, as well as future law enforcement and legislative or regulatory actions, may adversely affect the value of, and the returns on, the mortgage loans and mortgage securities we currently

own or may acquire in the future.

In January 2014, new regulations promulgated by the Consumer Financial Protection Bureau (CFPB) under the Dodd-Frank Act became effective that require mortgage lenders, prior to originating most residential mortgage loans, to make a determination of a borrower's ability to repay the loan and establish protections from liability under this requirement for mortgages that meet certain criteria, so-called qualified mortgages. Under these regulations, if a mortgage lender does not appropriately establish a borrower's ability to repay the loan, the borrower may be able to assert against the originator of the loan or any subsequent transferee, as a defense to foreclosure by way of recoupment or setoff, a violation of the ability-to-repay regulations. The impact of these ability-to-repay regulations on the availability of mortgage credit, the mortgage finance market, and our ability to securitize residential mortgage loans is unclear. The actual short- and long-term impact of these ability-to-repay regulations on us will depend, in large part, on how the credit rating agencies, triple-A securitization investors, warehouse lenders we borrow from, and other mortgage market investors assess the investment risks that result from the new regulations, including, for example, how they assess investment risks associated with residential mortgage loans that have an interest-only payment feature or loans under which the borrower has a debt-to-income ratio of more than 43% (as these types of loans have historically accounted for a portion of the loans we have securitized, but they are not considered qualified mortgages under the ability-to-repay regulations). If these and other regulations have a negative impact on the volume of mortgage loan originations or on our ability to finance, sell, or securitize residential mortgage loans, it could adversely affect our business and financial results.

Over the course of 2012 and 2013, certain counties, cities and other municipalities took steps to begin to consider how the power of eminent domain could be used to acquire residential mortgage loans from private-label securitization trusts and additional

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municipalities may be similarly considering this matter or may do so in the future. To the extent municipalities or other governmental authorities proceed to implement and carry out these or similar proposals and acquire residential mortgage loans from securitization trusts in which we hold an economic interest, there would likely be a negative impact on the value of our interests in those securitization trusts and a negative impact on our ability to engage in future securitizations (or on the returns we would otherwise expect to earn from executing future securitizations), which impacts could be material.

Ultimately, we cannot assure you of the impact that governmental actions may have on our business or the financial markets and, in fact, they may adversely affect us, possibly materially. We cannot predict whether or when such actions may occur or what unintended or unanticipated impacts, if any, such actions could have on our business and financial results. Even after governmental actions have been taken and we believe we understand the impacts of those actions, we may not be able to effectively respond to them so as to avoid a negative impact on our business or financial results.

The nature of the assets we hold and the investments we make expose us to credit risk that could negatively impact the value of those assets and investments, our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.

Overview of credit risk

We assume credit risk primarily through the ownership of securities backed by residential and commercial real estate loans and through direct investments in residential and commercial real estate loans. We may also assume similar credit risks through other types of transactions with counterparties who are seeking to reduce their exposure to credit risk. Credit losses on residential real estate loans can occur for many reasons, including: fraud; poor underwriting; poor servicing practices; weak economic conditions; increases in payments required to be made by borrowers; declines in the value of homes; earthquakes, the effects of climate change (including flooding, drought, and severe weather) and other natural events; uninsured property loss; over-leveraging of the borrower; costs of remediation of environmental conditions, such as indoor mold; changes in zoning or building codes and the related costs of compliance; acts of war or terrorism; changes in legal protections for lenders and other changes in law or regulation; and personal events affecting borrowers, such as reduction in income, job loss, divorce, or health problems. In addition, the amount and timing of credit losses could be affected by loan modifications, delays in the liquidation process, documentation errors, and other action by servicers. Weakness in the U.S. economy or the housing market could cause our credit losses to increase beyond levels that we currently anticipate.

In addition, rising interest rates may increase the credit risks associated with certain residential real estate loans. For example, the interest rate is adjustable for many of the loans held at securitization entities we have sponsored and for a portion of the loans underlying residential securities we have acquired from securitizations sponsored by others. Accordingly, when short-term interest rates rise, required monthly payments from homeowners will rise under the terms of these adjustable-rate mortgages, and this may increase borrowers' delinquencies and defaults.

Credit losses on commercial real estate loans can occur for many of the reasons noted above for residential real estate loans. Losses on commercial real estate loans can also occur for other reasons including decreases in the net operating income from the underlying property, which could be adversely affected by a weak U.S. or international economy. Moreover, at any given time, most or all of our commercial real estate loans are not fully amortizing and, therefore, the borrower's ability to repay the principal when due may depend upon the ability of the borrower to refinance or sell the property at maturity.

Commercial real estate loans are particularly sensitive to changes in the local economy, so even minor local adverse economic events may adversely affect the performance of commercial real estate assets. We are typically exposed to credit risk associated with both senior and subordinated commercial loans, and much of our exposure to credit risk associated with commercial loans is in the form of subordinate financing (e.g., mezzanine loans, b-notes, preferred equity, and subordinated interests in securitized pools). We directly originate commercial loans and may participate in loans originated by others (including through ownership of commercial mortgage-backed securities). Directly originating commercial loans exposes us to credit, legal, and other risks that may be greater than risks associated with loans we acquire or participate in that are originated by others. We may incur losses on commercial real estate loans and securities for reasons not necessarily related to an adverse change in the performance of the property (or properties) associated with any such loan or the loan (or loans) underlying any such security. This includes bankruptcy by the owner of the property, issues regarding the form of ownership of the property, poor property management, origination errors, inaccurate appraisals, fraud, and non-timely actions by servicers. If and when these problems become apparent, we may have little or no recourse to the borrower, issuer of the securities, or seller of the loan and we may incur credit losses as a result.

We may have heightened credit losses associated with certain securities and investments we own.

Within a securitization of residential or commercial real estate loans, various securities are created, each of which has varying degrees of credit risk. We may own the securities in which there is more (or the most) concentrated credit risk associated with the underlying real estate loans.

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In general, losses on an asset securing a residential or commercial real estate loan included in a securitization will be borne first by the owner of the property (i.e., the owner will first lose any equity invested in the property) and, thereafter, by mezzanine or preferred equity investors, if any, then by a cash reserve fund or letter of credit, if any, then by the first-loss security holder, and then by holders of more senior securities. In the event the losses incurred upon default on the loan exceed any equity support, reserve fund, letter of credit, and classes of securities junior to those in which we invest (if any), we may not be able to recover all of our investment in the securities we hold. In addition, if the underlying properties have been overvalued by the originating appraiser or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related security, then the first-loss securities may suffer a total loss of principal, followed by losses on the second-loss and then third-loss securities (or other residential and commercial securities that we own). In addition, with respect to residential securities we own, we may be subject to risks associated with the determination by a loan servicer to discontinue servicing advances (advances of mortgage interest payments not made by a delinquent borrower) if they deem continued advances to be unrecoverable, which could reduce the value of these securities or impair our ability to project and realize future cash flows from these securities.

For loans or other investments we own directly (not through a securitization structure), we will most likely be in a position to incur credit losses should they occur only after losses are borne by the owner of the property (e.g., by a reduction in the owner's equity stake in the property). We may take actions available to us in an attempt to protect our position and mitigate the amount of credit losses, but these actions may not prove to be successful and could result in our increasing the amount of credit losses we ultimately incur on a loan.

The nature of the assets underlying some of the securities and investments we hold could increase the credit risk of those securities.

For certain types of loans underlying securities we may own or acquire, the loan rate or borrower payment rate may increase over time, increasing the potential for default. For example, securities may be backed by residential real estate loans that have negative amortization features. The rate at which interest accrues on these loans may change more frequently or to a greater extent than payment adjustments on an adjustable-rate loan, and adjustments of monthly payments may be subject to limitations or may be limited by the borrower's option to pay less than the full accrual rate. As a result, the amount of interest accruing on the remaining principal balance of the loans at the applicable adjustable mortgage loan rate may exceed the amount of the monthly payment. To the extent we are exposed to it, this is particularly a risk in a rising interest rate environment. Negative amortization occurs when the resulting excess (of interest owed over interest paid) is added to the unpaid principal balance of the related adjustable mortgage loan. For certain loans that have a negative amortization feature, the required monthly payment is increased after a specified number of months or after a maximum amount of negative amortization has occurred in order to amortize fully the loan by the end of its original term. Other negative amortizing loans limit the amount by which the monthly payment can be increased, which results in a larger final payment at maturity. As a result, negatively amortizing loans have performance characteristics similar to those of balloon loans. Negative amortization may result in increases in delinquencies, loan loss severity, and loan defaults, which may, in turn, result in payment delays and credit losses on our investments. Other types of loans and investments to which we are exposed, such as hybrid loans and adjustable-rate loans, may also have greater credit risk than more traditional amortizing fixed-rate mortgage loans.

Most or all of the commercial real estate loan assets we own are only partially amortizing or do not provide for any principal amortization prior to a balloon principal payment at maturity. Commercial loans that only partially amortize or that have a balloon principal payment at maturity may have a higher risk of default at maturity than fully amortizing loans. In addition, since most of the principal of these loans is repaid at maturity, the amount of loss upon

default is generally greater than on other loans that provide for more principal amortization.

We have concentrated credit risk in certain geographical regions and may be disproportionately affected by an economic or housing downturn, natural disaster, terrorist event, climate change, or any other adverse event specific to those regions.

A decline in the economy or difficulties in certain real estate markets, such as a high level of foreclosures in a particular area, are likely to cause a decline in the value of residential and commercial properties. This, in turn, will increase the risk of delinquency, default, and foreclosure on real estate underlying securities and loans we hold with properties in those regions. This may then adversely affect our credit loss experience and other aspects of our business, including our ability to securitize (or otherwise sell) real estate loans and securities.

The occurrence of a natural disaster (such as an earthquake, tornado, hurricane, or flood), or the effects of climate change (including flooding, drought, and severe weather), may cause decreases in the value of real estate (including sudden or abrupt changes) and would likely reduce the value of the properties collateralizing commercial and residential real estate loans we own or those underlying the securities or other investments we own. Since certain natural disasters may not typically be covered by the standard hazard insurance policies maintained by borrowers, the borrowers may have to pay for repairs due to the disasters. Borrowers may not repair their property or may stop paying their mortgage loans under those circumstances, especially if the property is damaged. This would likely cause foreclosures to increase and lead to higher credit losses on our loans or investments or on the pool of mortgage loans underlying securities we own.

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A significant number of residential real estate loans that underlie the securities we own are secured by properties in California and, thus, we have a higher concentration of credit risk within California than in other states. Additional states where we have concentrations of residential loan credit risk are set forth in *Note 6* to the Financial Statements within this Annual Report on Form 10-K. Balances on commercial loans we originate or otherwise acquire are larger than residential loans and we may continue to have a geographically concentrated commercial loan portfolio until our portfolio increases in size. While we intend to originate commercial loans throughout the country, our commercial loans are generally concentrated in or near major metropolitan areas. Additional information on geographic distribution of our commercial loan portfolio is set forth in *Note 7* to the Financial Statements within this Annual Report on Form 10-K.

The timing of credit losses can harm our economic returns.

The timing of credit losses can be a material factor in our economic returns from residential and commercial loans, investments, and securities. If unanticipated losses occur within the first few years after a loan is originated, an investment is made, or a securitization is completed, those losses could have a greater negative impact on our investment returns than unanticipated losses on more seasoned loans, investments, or securities. In addition, higher levels of delinquencies and cumulative credit losses within a securitized loan pool can delay our receipt of principal and interest that is due to us under the terms of the securities backed by that pool. This would also lower our economic returns. The timing of credit losses could be affected by the creditworthiness of the borrower, the borrower's willingness and ability to continue to make payments, and new legislation, legal actions, or programs that allow for the modification of loans or ability for borrowers to get relief through bankruptcy or other avenues.

Our efforts to manage credit risks may fail.

We attempt to manage risks of credit losses by continually evaluating our investments for impairment indicators and establishing reserves under GAAP for credit and other risks based upon our assessment of these risks. We cannot establish credit reserves for tax accounting purposes. The amount of reserves that we establish may prove to be insufficient, which would negatively impact our financial results and would result in earnings volatility. In addition, cash and other capital we hold to help us manage credit and other risks and liquidity issues may prove to be insufficient. If these increased credit losses are greater than we anticipated and we need to increase our credit reserves, our GAAP earnings might be reduced. Increased credit losses may also adversely affect our cash flows, ability to invest, dividend distribution requirements and payments, asset fair values, access to short-term borrowings, and ability to securitize or finance assets.

Despite our efforts to manage credit risk, there are many aspects of credit risk that we cannot control. Our quality control and loss mitigation policies and procedures may not be successful in limiting future delinquencies, defaults, and losses, or they may not be cost effective. Our underwriting reviews may not be effective. The securitizations in which we have invested may not receive funds that we believe are due from mortgage insurance companies and other counterparties. Loan servicing companies may not cooperate with our loss mitigation efforts or those efforts may be ineffective. Service providers to securitizations, such as trustees, loans servicers, bond insurance providers, and custodians, may not perform in a manner that promotes our interests. Delay of foreclosures could delay resolution and increase ultimate loss severities, as a result.

The value of the homes collateralizing or underlying residential loans or investments may decline. The value of the commercial properties collateralizing or underlying commercial loans or investments may decline. The frequency of default and the loss severity on loans upon default may be greater than we anticipate. Interest-only loans, negative

amortization loans, adjustable-rate loans, larger balance loans, reduced documentation loans, subprime loans, alt-a loans, second lien loans, loans in certain locations, residential mortgage loans that are not qualified mortgages under regulations promulgated by the CFPB, and loans or investments that are partially collateralized by non-real estate assets may have increased risks and severity of loss. If property securing or underlying loans become real estate owned as a result of foreclosure, we bear the risk of not being able to sell the property and recovering our investment and of being exposed to the risks attendant to the ownership of real property.

Changes in consumer behavior, bankruptcy laws, tax laws, regulation of the mortgage industry, and other laws may exacerbate loan or investment losses. Changes in rules that would cause loans owned by a securitization entity to be modified may not be beneficial to our interests if the modifications reduce the interest we earn and increase the eventual severity of a loss. In some states and circumstances, the securitizations in which we invest have recourse as owner of the loan against the borrower's other assets and income in the event of loan default. However, in most cases, the value of the underlying property will be the sole effective source of funds for any recoveries. Other changes or actions by judges or legislators regarding mortgage loans and contracts, including the voiding of certain portions of these agreements, may reduce our earnings, impair our ability to mitigate losses, or increase the probability and severity of losses. Any expansion of our loss mitigation efforts as we grow our portfolio could increase our operating costs and the expanded loss mitigation efforts may not reduce our future credit losses.

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Credit ratings assigned to debt securities by the credit rating agencies may not accurately reflect the risks associated with those securities. Furthermore, downgrades in the credit ratings of bond insurers or any downgrades in the credit ratings of mortgage insurers could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business and operations.

We generally do not consider credit ratings in assessing our estimates of future cash flows and desirability of our investments (although our assessment of the quality of an investment may prove to be inaccurate and we may incur credit losses in excess of our initial expectations). The assignment of an investment grade rating to a security by a rating agency does not mean that there is not credit risk associated with the security or that the risk of a credit loss with respect to such security is necessarily remote. Many of the securities we own do have credit ratings and, to the extent we securitize loans and securities, we expect to retain credit rating agencies to provide ratings on the securities created by these securitization entities (as we have in the past).

Rating agencies rate debt securities based upon their assessment of the safety of the receipt of principal and interest payments. Rating agencies do not consider the risks of fluctuations in fair value or other factors that may influence the value of debt securities and, therefore, any assigned credit rating may not fully reflect the true risks of an investment in securities. Also, rating agencies may fail to make timely adjustments to credit ratings based on available data or changes in economic outlook or may otherwise fail to make changes in credit ratings in response to subsequent events, so that our investments may be better or worse than the ratings indicate. Credit rating agencies may change their methods of evaluating credit risk and determining ratings on securities backed by real estate loans and securities. These changes may occur quickly and often. The market's ability to understand and absorb these changes and the impact to the securitization market in general are difficult to predict. Such changes may have an impact on the amount of investment-grade and non-investment-grade securities that are created or placed on the market in the future. Downgrades to the ratings of securities could have an adverse effect on the value of some of our investments and our cash flows from those investments.

Currently, and in the future, some of the loans we own or that underlie mortgage-backed securities we own may be insured in part by mortgage insurers or financial guarantors. Mortgage insurance protects the lender or other holder of a loan up to a specified amount, in the event the borrower defaults on the loan. Mortgage insurance is generally obtained only when the principal amount of the loan at the time of origination is greater than 80% of the value of the property (loan-to-value), although it may not always be obtained in these circumstances. Any inability of the mortgage insurers to pay in full the insured portion of the loans that we hold would adversely affect the value of the securities we own that are backed by these loans, which could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business.

Changes in prepayment rates of residential mortgage loans could reduce our earnings, dividends, cash flows, and access to liquidity. Similarly, with respect to commercial real estate loans, borrowers' decisions to prepay or extend loans could reduce our earnings, dividends, cash flows, and access to liquidity.

The economic returns we earn from most of the residential real estate securities and loans we own (directly or indirectly) are affected by the rate of prepayment of the underlying residential mortgage loans. Prepayments are difficult to accurately predict and adverse changes in the rate of prepayment could reduce our cash flows, earnings, and dividends. Adverse changes in cash flows would likely reduce the fair values of many of our assets, which could reduce our ability to borrow against our assets and may cause market valuation adjustments for GAAP purposes, which could reduce our reported earnings. While we estimate prepayment rates to determine the effective yield of our assets and valuations, these estimates are not precise and prepayment rates do not necessarily change in a predictable

manner as a function of interest rate changes. Prepayment rates can change rapidly. As a result, changes can cause volatility in our financial results, affect our ability to securitize assets, affect our ability to fund acquisitions, and have other negative impacts on our ability to generate earnings.

We own a number of securities backed by residential loans that are particularly sensitive to changes in prepayments rates. These securities include interest-only securities (IOs) that we acquire from third parties and from our Sequoia entities. Faster prepayments than we anticipated on the underlying loans backing these IOs will have an adverse effect on our returns on these investments and may result in losses. Similarly, we own mortgage servicing rights, or MSRs, associated with residential mortgage loans that are particularly sensitive to changes in prepayments rates. As the owner of an MSR, we are entitled to a portion of the interest payments made by the borrower in respect of the associated loan and we are responsible for hiring and compensating a sub-servicer to directly service the associated loan. Faster prepayments than we anticipate on loans associated with MSRs we own will have an adverse effect on our returns from these MSRs and may result in losses.

Some of the commercial real estate loans we originate or hold may allow the borrower to make prepayments without incurring a prepayment penalty and some may include provisions allowing the borrower to extend the term of the loan beyond the originally scheduled maturity. Because the decision to prepay or extend a commercial loan is controlled by the borrower, we may not accurately anticipate the timing of these events, which could affect the earnings and cash flows we anticipate and could impact our ability to finance these assets.

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Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and increased volatility in our earnings.

Changes in interest rates, the interrelationships between various interest rates, and interest rate volatility could have negative effects on our earnings, the fair value of our assets and liabilities, loan prepayment rates, and our access to liquidity. Changes in interest rates can also harm the credit performance of our assets. We generally seek to hedge some but not all interest rate risks. Our hedging may not work effectively and we may change our hedging strategies or the degree or type of interest rate risk we assume.

Some of the loans and securities we own or may acquire have adjustable-rate coupons (i.e., they may earn interest at a rate that adjusts periodically based on an interest rate index). The cash flows we receive from these assets may vary as a function of interest rates, as may the reported earnings generated by these assets. We also acquire loans and securities for future sale, as assets we are accumulating for securitization, or as a longer term investment. We expect to fund assets with a combination of equity, fixed rate debt and adjustable rate debt. To the extent we use adjustable rate debt to fund assets that have a fixed interest rate (or use fixed rate debt to fund assets that have an adjustable interest rate), an interest rate mismatch could exist and we could, for example, earn less (and fair values could decline) if interest rates rise, at least for a time. We may or may not seek to mitigate interest rate mismatches for these assets with hedges such as interest rate agreements and other derivatives and, to the extent we do use hedging techniques, they may not be successful.

Higher interest rates generally reduce the fair value of many of our assets, with the exception of our adjustable-rate assets. This may affect our earnings results, reduce our ability to securitize, re-securitize, or sell our assets, or reduce our liquidity. Higher interest rates could reduce the ability of borrowers to make interest payments or to refinance their loans. Higher interest rates could reduce property values and increased credit losses could result. Higher interest rates could reduce mortgage originations, thus reducing our opportunities to acquire new assets.

When short-term interest rates are high relative to long-term interest rates, an increase in adjustable-rate residential loan prepayments may occur, which would likely reduce our returns from owning interest-only securities backed by adjustable-rate residential loans.

We have significant investment and reinvestment risks.

New assets we originate or acquire may not generate yields as attractive as yields on our current assets, which could result in a decline in our earnings per share over time.

Assets we originate or acquire may not generate the economic returns and GAAP yields we expect. Realized cash flow could be significantly lower than expected and returns from new asset originations and acquisitions could be negative. In order to maintain our portfolio size and our earnings, we must reinvest in new assets a portion of the cash flows we receive from principal, interest, and sales. We receive monthly payments from many of our assets, consisting of principal and interest. In addition, occasionally some of our residential securities are called (effectively sold). We may also sell assets from time to time as part of our portfolio and capital management strategies. Principal payments, calls, and sales reduce the size of our current portfolio and generate cash for us.

If the assets we acquire in the future earn lower GAAP yields than do the assets we currently own, our reported earnings per share could decline over time as the older assets are paid down, are called, or are sold, assuming comparable expenses, credit costs, and market valuation adjustments. Under the effective yield method of accounting

that we use for GAAP purposes for some of our assets, we recognize yields on assets based on our assumptions regarding future cash flows. A portion of the cash flows we receive may be used to reduce our basis in these assets. As a result of these various factors, our basis for GAAP amortization purposes may be lower than their current fair values. Assets with a lower GAAP basis than current fair values generate higher GAAP yields, yields that are not necessarily available on newly acquired assets. Future economic conditions, including credit results, prepayment patterns, and interest rate trends, are difficult to project with accuracy over the life of the assets we acquire, so there will be volatility in the reported returns over time.

Our growth may be limited if assets are not available or not available at attractive prices.

To reinvest proceeds from principal repayments and deploy capital we raise, we must originate or acquire new assets. If the availability of new assets is limited, we may not be able to originate or acquire assets that will generate attractive returns. Generally, asset supply can be reduced if originations of a particular product are reduced or if there are few sales in the secondary market of seasoned product from existing portfolios. In particular, assets we believe have a favorable risk/reward ratio may not be available for purchase.

We do not originate residential loans; rather, we rely on the origination market to supply the types of loans we seek to invest in. At times, due to increases in interest rates, heightened credit concerns, strengthened underwriting standards, increased regulation, and/or concerns about economic growth or housing values, the volume of originations may decrease significantly. For example, in recent

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years residential mortgage interest rates were generally declining, with the result that a significant portion of industry-wide origination volumes have been related to residential borrowers refinancing existing mortgage loans. More recently, residential mortgage interest rates have been increasing or remaining steady. To the extent interest rates increase or remain steady, the volume of refinance loans is likely to decline significantly and this volume may not return to previous levels. A reduced volume of loan originations may make it difficult for us to acquire loans and securities.

We originate commercial loans, but we may not be willing to provide the level of loan proceeds to the borrower or interest rate that borrowers find acceptable or that matches our competitors. While the overall industry-wide volume of commercial real estate loan originations and financings is increasing from prior low levels, it is not at the volume the industry has experienced in the past. And, the high-quality commercial assets we seek to finance are highly sought after by numerous lenders.

The supply of new issue RMBS collateralized by jumbo mortgage loans available for purchase could be adversely affected if the economics of executing securitizations are not favorable or if the regulations governing the execution of securitizations discourage or preclude certain potential market participants from engaging in these transactions. In addition, if there is not a robust market for triple-A rated securities, the supply of real estate subordinate securities could be significantly diminished.

Investments in diverse types of assets and businesses could expose us to new, different, or increased risks.

We have invested in and may in the future invest in a variety of real estate and non-real estate related assets that may not be closely related to the types of investments we have traditionally made. Additionally, we may enter into or engage in various types of securitizations, transactions, services, and other operating businesses that are different than the types we have traditionally entered into or engaged in, including, for example, ownership of MSRs associated with residential mortgage loans, which we began to increase our holdings of during 2012 and 2013. Any of these actions may expose us to new, different, or increased investment, operational, financial, or management risks. We may invest in non-real estate asset-backed securities (ABS), corporate debt, or equity. We have invested in diverse types of IOs from residential and commercial securitizations sponsored by us or by others. The higher credit and prepayment risks associated with these types of investments may increase our exposure to losses. We may invest in non-U.S. assets that may expose us to currency risks (which we may choose not to hedge) and different types of credit, prepayment, hedging, interest rate, liquidity, legal, and other risks. We originate first mortgage commercial loans primarily for the sale to others (while, in some cases, retaining a subordinate interest in these loans or retaining subordinate financing for the same property) and this exposes us to certain representation and warranty, aggregation, market value, and other risks on loan balances in excess of our potential investments.

In addition, when investing in assets or businesses we are exposed to the risk that those assets, or interest income or revenue generated by those assets or businesses, result in our not meeting the requirements to maintain our REIT status or our status as exempt from registration under the Investment Company Act of 1940, as amended (Investment Company Act), as further described in the risk factors titled *Redwood has elected to be a REIT and, as such, is required to meet certain tests in order to maintain its REIT status. This adds complexity and costs to running our business and exposes us to additional risks* and *Conducting our business in a manner so that we are exempt from registration under, and in compliance with, the Investment Company Act may reduce our flexibility and could limit our ability to pursue certain opportunities. At the same time, failure to continue to qualify for exemption from the Investment Company Act could adversely affect us.*

We may change our investment strategy or financing plans, which may result in riskier investments and diminished returns.

We may change our investment strategy or financing plans at any time, which could result in our making investments that are different from, and possibly riskier than, the investments we have previously made or described. A change in our investment strategy or financing plans may increase our exposure to interest rate and default risk and real estate market fluctuations. Decisions to employ additional leverage could increase the risk inherent in our investment strategy. Furthermore, a change in our investment strategy could result in our making investments in new asset categories or in different proportions among asset categories than we previously have. For example, we could in the future determine to invest a greater proportion of our assets in securities backed by subprime residential mortgage loans. These changes could result in our making riskier investments, which could ultimately have an adverse effect on our financial returns. Alternatively, we could determine to change our investment strategy or financing plans to be more risk averse, resulting in potentially lower returns, which could also have an adverse effect on our financial returns.

The performance of the assets we own and the investments we make will vary and may not meet our earnings or cash flow expectations. In addition, the cash flows and earnings from, and market values of, securities, loans, and other assets we own may be volatile.

We seek to manage certain of the risks associated with acquiring, originating, holding, selling, and managing real estate loans and securities and other real estate-related investments. No amount of risk management or mitigation, however, can change the variable nature of the cash flows of, fair values of, and financial results generated by these loans, securities, and other assets. Changes in the

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credit performance of, or the prepayments on, these investments, including real estate loans and the loans underlying these securities, and changes in interest rates impact the cash flows on these securities and investments, and the impact could be significant for our loans, securities, and other assets with concentrated risks. Changes in cash flows lead to changes in our return on investment and also to potential variability in and level of reported income. The revenue recognized on some of our assets is based on an estimate of the yield over the remaining life of the asset. Thus, changes in our estimates of expected cash flow from an asset will result in changes in our reported earnings on that asset in the current reporting period. We may be forced to recognize adverse changes in expected future cash flows as a current expense, further adding to earnings volatility.

Changes in the fair values of our assets, liabilities, and derivatives can have various negative effects on us, including reduced earnings, increased earnings volatility, and volatility in our book value.

Fair values for our assets and liabilities, including derivatives, can be volatile and our revenue and income can be impacted by changes in fair values. The fair values can change rapidly and significantly and changes can result from changes in interest rates, perceived risk, supply, demand, and actual and projected cash flows, prepayments, and credit performance. A decrease in fair value may not necessarily be the result of deterioration in future cash flows. Fair values for illiquid assets can be difficult to estimate, which may lead to volatility and uncertainty of earnings and book value.

For GAAP purposes, we may mark to market some, but not all, of the assets and liabilities on our consolidated balance sheet. In addition, valuation adjustments on certain consolidated assets and many of our derivatives are reflected in our consolidated statement of income. Assets that are funded with certain liabilities and hedges may have differing mark-to-market treatment than the liability or hedge. If we sell an asset that has not been marked to market through our consolidated statement of income at a reduced market price relative to its cost basis, our reported earnings will be reduced.

Our loan sale profit margins are generally reflective of gains (or losses) over the period from when we identify a loan for purchase until we subsequently sell or securitize the loan. These profit margins may encompass elements of positive or negative market valuation adjustments on loans, hedging gains or losses associated with related risk management activities, and any other related transaction expenses; however, under GAAP, the differing elements may be realized unevenly over the course of one or more quarters for financial reporting purposes, with the result that our financial results may be more volatile and less reflective of the underlying economics of our business activity. For example, at the end of a quarterly or annual financial reporting period, estimated market valuation adjustments on our pipeline of jumbo residential loans identified for purchase, but not yet purchased, may be a negative amount that, in accordance with GAAP, is not reflected in our financial results for that period (but would generally be reflected in a subsequent period when the associated loans are acquired). At the same time, certain offsetting hedging gains may, in accordance with GAAP, have been recorded during that period with the result that hedging gains and offsetting negative market valuation adjustments may impact our reported financial results in different reporting periods.

Our calculations of the fair value of the securities, loans, MSR's, derivatives, and certain other assets we own or consolidate are based upon assumptions that are inherently subjective and involve a high degree of management judgment.

We report the fair values of securities, loans, MSR's, derivatives, and certain other assets at fair value on our consolidated balance sheets. In computing the fair values for these assets we may make a number of market-based assumptions, including assumptions regarding future interest rates, prepayment rates, discount rates, credit loss rates,

and the timing of credit losses. These assumptions are inherently subjective and involve a high degree of management judgment, particularly for illiquid securities and other assets for which market prices are not readily determinable. For further information regarding our assets recorded at fair value see *Note 5* to the Financial Statements within this Annual Report on Form 10-K. Use of different assumptions could materially affect our fair value calculations and our financial results. Further discussion of the risk of our ownership and valuation of illiquid securities is set forth in the immediately following risk factor.

Investments we make, hedging transactions that we enter into, and the manner in which we finance our investments and operations expose us to various risks, including liquidity risk, risks associated with the use of leverage, market risks, and counterparty risk.

Many of our investments have limited liquidity.

Many of the residential and commercial securities we own are generally illiquid – that is, there is not a significant pool of potential investors that are likely to invest in these, or similar, securities. This illiquidity can also exist for the residential loans we hold and commercial loans we originate. In fact, at times, the vast majority of the assets we own are illiquid. In turbulent markets, it is likely that the securities, loans, and other assets we own may become even less liquid. As a result, we may not be able to sell certain

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assets at opportune times or at attractive prices or we may incur significant losses upon sale of these assets, should we want or need to sell them.

Our level of indebtedness and liabilities could limit cash flow available for our operations, expose us to risks that could adversely affect our business, financial condition and results of operations and impair our ability to satisfy our obligations under our convertible notes and other debt instruments.

At December 31, 2013, our total consolidated liabilities (excluding indebtedness associated with asset-backed securities issued by consolidated Sequoia entities, a residential resecuritization entity, and a commercial securitization entity, for which we are not liable) was \$1.4 billion, including \$287.5 million of outstanding convertible notes. We may also incur additional indebtedness to meet future financing needs. Our indebtedness could have significant negative consequences for our business, results of operations and financial condition, including:

increasing our vulnerability to adverse economic and industry conditions;

limiting our ability to obtain additional financing;

requiring the dedication of a substantial portion of our cash flow from operations to service our indebtedness, thereby reducing the amount of our cash flow available for other purposes;

limiting our flexibility in planning for, or reacting to, changes in our business;

dilution experienced by our existing stockholders as a result of the conversion of the convertible notes into shares of common stock; and

placing us at a possible competitive disadvantage with less leveraged competitors and competitors that may have better access to capital resources.

We cannot assure you that we will be able to continue to maintain sufficient cash reserves or continue to generate cash flow from operations at levels sufficient to permit us to pay principal, premium, if any, and interest on our indebtedness, or that our cash needs will not increase. If we are unable to generate sufficient cash flow or otherwise obtain funds necessary to make required payments, or if we fail to comply with the various requirements of our indebtedness then outstanding, we would be in default, which would permit the holders of the affected indebtedness to accelerate the maturity of such indebtedness and could cause defaults under our other indebtedness. Any default under any indebtedness could have a material adverse effect on our business, results of operations and financial condition. For an additional discussion of our outstanding indebtedness, see Part II, Item 7 of this Annual Report on Form 10-K 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* .

Our use of short-term financial leverage could expose us to increased risks.

We fund the residential and commercial loans we acquire in anticipation of a future sale or securitization with a combination of equity and short-term debt. In addition, we also make investments in securities and loans financed with short-term debt. By incurring this debt (i.e., by applying financial leverage), we expect to generate more attractive returns on our invested equity capital. However, as a result of using financial leverage (whether for the accumulation of loans or related to longer-term investments), we could also incur significant losses if our borrowing costs increase relative to the earnings on our assets and costs of any related hedges. Financing facility creditors may also force us to sell assets pledged as collateral under adverse market conditions to meet margin calls, for example, in the event of a decrease in the fair values of the assets pledged as collateral. Liquidation of the collateral could create negative tax consequences and raise REIT qualification issues. Further discussion of the risk associated with maintaining our REIT status is set forth in the risk factor titled *Redwood has elected to be a REIT and, as such, is required to meet certain tests in order to maintain its REIT status. This adds complexity and costs to running our business and exposes us to additional risks.* In addition, we make financial covenants to creditors in connection with incurring short-term debt, such as covenants relating to our maintaining a minimum amount of tangible net worth or stockholders' equity and/or a minimum amount of liquid assets. If we fail to comply with these financial covenants we would be in default under our financing facilities, which could result in, among other things, the liquidation of collateral we have pledged pursuant to these facilities under adverse market conditions and the inability to incur additional borrowings to finance our business activities. A further discussion of financial covenants we are subject to and related risks associated with our use of short-term debt is set forth in Part II, Item 7 of this Annual Report on Form 10-K under the heading, *Risks*

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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.

The inability to access financial leverage through warehouse and repurchase facilities, credit facilities, or other forms of debt financing may inhibit our ability to execute our business plan, which could have a material adverse effect on our financial results, financial condition, and business.

Our ability to fund our business and our investment strategy depends on our securing warehouse, repurchase, or other forms of debt financing (or leverage) on acceptable terms. For example, pending the sale or securitization of a pool of mortgage loans or other assets we generally fund the acquisition of those mortgage loans or other assets through borrowings from warehouse, repurchase, and credit facilities, and other forms of short-term financing.

We cannot assure you that we will be successful in establishing sufficient sources of short-term debt when needed. In addition, because of its short-term nature, lenders may decline to renew our short-term debt upon maturity or expiration, and it may be difficult for us to obtain continued short-term financing. During certain periods, lenders may curtail their willingness to provide financing, as liquidity in short-term debt markets, including repurchase facilities and commercial paper markets, can be withdrawn suddenly, making it difficult or expensive to renew short-term borrowings as they mature. To the extent our business or investment strategy calls for us to access financing and counterparties are unable or unwilling to lend to us, then our business and financial results will be adversely affected. In addition, it is possible that lenders who provide us with financing could experience changes in their ability to advance funds to us, independent of our performance or the performance of our investments, in which case funds we had planned to be able to access may not be available to us.

Hedging activities may reduce earnings, may fail to reduce earnings volatility, and may fail to protect our capital in difficult economic environments.

We attempt to hedge certain interest rate risks (and, at times, prepayment risks and fair values) by balancing the characteristics of our assets and associated (existing and anticipated) liabilities with respect to those risks and entering into various interest rate agreements. The number and scope of the interest rate agreements we utilize may vary significantly over time. We generally seek to enter into interest rate agreements that provide an appropriate and efficient method for hedging certain risks related to changes in interest rates.

The use of interest rate agreements and other instruments to hedge certain of our risks may well have the effect over time of lowering long-term earnings to the extent these risks do not materialize. To the extent that we hedge, it is usually to seek to protect us from some of the effects of short-term interest rate volatility, to lower short-term earnings volatility, to stabilize liability costs or fair values, to stabilize our economic returns from or meet rating agency requirements with respect to a securitization transaction, or to stabilize the future cost of anticipated issuance of securities by a securitization entity. Hedging may not achieve our desired goals. Hedging with respect to the pipeline of loans we plan to purchase may not be effective due to loan fallout or other reasons. Using interest rate agreements as a hedge may increase short-term earnings volatility, especially if we do not elect certain accounting treatments for our hedges. Reductions in fair values of interest rate agreements may not be offset by increases in fair values of the assets or liabilities being hedged. Conversely, increases in fair values of interest rate agreements may not fully offset declines in fair values of assets or liabilities being hedged. Changes in fair values of interest rate agreements may require us to pledge significant amounts of cash or other acceptable forms of collateral.

We also may hedge by taking short, forward, or long positions in U.S. Treasuries, mortgage securities, or other cash instruments. We may take both long and short positions in credit derivative transactions linked to real estate assets. These derivatives may have additional risks to us, such as: liquidity risk, due to fact that there may not be a ready market into which we could sell these derivatives if needed; basis risk, which could result in a decline in value or a requirement to make a cash payment as a result of changes in interest rates; and the risk that a counterparty to a derivative is not willing or able to perform its obligations to us due to its financial condition or otherwise.

Our earnings may be subject to fluctuations from quarter to quarter as a result of the accounting treatment for certain derivatives or for assets or liabilities whose terms do not necessarily match those used for derivatives, or as a result of our inability to meet the requirements necessary to obtain specific hedge accounting treatment for certain derivatives.

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We enter into derivative contracts that may expose us to contingent liabilities and those contingent liabilities may not appear on our balance sheet. We may invest in synthetic securities, credit default swaps, and other credit derivatives, which expose us to additional risks.

We enter into derivative contracts, including interest rate swaps, options and futures, that could require us to make cash payments in certain circumstances. Potential payment obligations would be contingent liabilities and may not appear on our balance sheet. Our ability to satisfy these contingent liabilities depends on the liquidity of our assets and our access to capital and cash. The need to fund these contingent liabilities could adversely impact our financial condition.

We may in the future invest in synthetic securities, credit default swaps, and other credit derivatives that reference other real estate securities or indices. These investments may present risks in excess of those resulting from the referenced security or index. These investments are typically contractual relationships with counterparties and not acquisitions of referenced securities or other assets. In these types of investments, we have no right directly to enforce compliance with the terms of the referenced security or other assets and we have no voting or other consensual rights of ownership with respect to the referenced security or other assets. In the event of insolvency of a counterparty, we will be treated as a general creditor of the counterparty and will have no claim of title with respect to the referenced security.

Hedging activities may subject us to increased regulation.

Under the Dodd-Frank Act, there is increased regulation of companies, such as Redwood and certain of its subsidiaries, that enter into interest rate hedging agreements and other hedging instruments and derivatives. This increased regulation could result in Redwood or certain of its subsidiaries being required to register and be regulated as a commodity pool operator or a commodity trading advisor. If we are not able to maintain an exemption from these regulations, it could have a negative impact on our business or financial results. Moreover, rules requiring central clearing of certain interest rate swap and other transactions, as well as rules relating to margin and capital requirements for swap transactions and regulated participants in the swap markets, as well as other swap market regulatory reforms, may increase the cost or decrease the availability to us of hedging transactions, and may also limit our ability to include swaps in our securitization transactions.

Our results could be adversely affected by counterparty credit risk.

We have credit risks that are generally related to the counterparties with which we do business. There is a risk that counterparties will fail to perform under their contractual arrangements with us and this risk is usually more pronounced during an economic downturn. Counterparties may seek to eliminate credit exposure by entering into offsetting, or back-to-back, hedging transactions, and the ability of a counterparty to settle a synthetic transaction may be dependent on whether the counterparties to the back-to-back transactions perform their delivery obligations. Those risks of non-performance may differ materially from the risks entailed in exchange-traded transactions, which generally are backed by clearing organization guarantees, daily mark-to-market and settlement of positions, and segregation and minimum capital requirements applicable to intermediaries. Transactions entered into directly between parties generally do not benefit from those protections, and expose the parties to the risk of counterparty default. Furthermore, there may be practical and timing problems associated with enforcing our rights to assets in the case of an insolvency of a counterparty.

In the event a counterparty to our short-term borrowings becomes insolvent, we may fail to recover the full value of our pledged collateral, thus reducing our earnings and liquidity. In the event a counterparty to our interest rate agreements, credit default swaps, or other derivatives becomes insolvent or interprets our agreements with it in a manner unfavorable to us, our ability to realize benefits from the hedge transaction may be diminished, any cash or collateral we pledged to the counterparty may be unrecoverable, and we may be forced to unwind these agreements at a loss. In the event that one of our servicers becomes insolvent or fails to perform, loan delinquencies and credit losses may increase and we may not receive the funds to which we are entitled. We attempt to diversify our counterparty exposure and (except with respect to loan representations and warranties) attempt to limit our counterparty exposure to counterparties with investment-grade credit ratings, although we may not always be able to do so. Our counterparty risk management strategy may prove ineffective and, accordingly, our earnings and cash flows could be adversely affected.

Adverse changes to the credit rating of the U.S. government or to the credit rating of the United Kingdom or one or more of the Eurozone nations by one or more of the major credit rating agencies could negatively impact the availability and cost to us of short-term debt financing and could adversely affect our business and financial results.

It is difficult to predict the impact of any change in the credit rating of the U.S. government or the United Kingdom, or of any change in the credit rating of one or more Eurozone nations; however, any change in the outlook for, or rating of, the U.S. government's creditworthiness or the creditworthiness of the United Kingdom or any Eurozone nations would likely have adverse

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impacts on, among other things, the economy in the U.S., the United Kingdom, and the Eurozone, financial markets, the cost of borrowing, the financial strength of counterparties we transact business with, and the value of assets we hold. Any such adverse impacts could negatively impact the availability to us of short-term debt financing, our cost of short-term debt financing, our business, and our financial results.

Through certain of our wholly-owned subsidiaries we have engaged in the past, and plan to continue to engage, in acquiring residential mortgage loans and originating commercial mortgage loans with the intent to sell these loans to third parties or hold them as investments. Similarly, we have engaged in the past, and plan to continue to engage, in acquiring residential MSRs. These types of transactions and investments expose us to potentially material risks.

Acquiring and originating mortgage loans with intent to sell these loans to third parties generally requires us to incur short-term debt, either on a recourse or non-recourse basis, to finance the accumulation of loans or other assets prior to sale. This type of debt may not be available to us, or may only be available to us on an uncommitted basis, including in circumstances where a line of credit had previously been made available or committed to us. In addition, the terms of any available debt may be unfavorable to us or impose restrictive covenants that could limit our business and operations or the violation of which could lead to losses and inhibit our ability to borrow in the future. We expect to pledge assets we acquire to secure the short-term debt we incur. To the extent this debt is recourse to us, if the fair value of the assets pledged as collateral declines, we would be required to increase the amount of collateral pledged to secure the debt or to repay all or a portion of the debt. Furthermore, if we are unable to complete the sale of these types of assets, it could have a negative impact on our financial results. In addition, when we originate or acquire assets for a sale, we make assumptions about the cash flows that will be generated from those assets and the market value of those assets. If these assumptions are wrong, or if market values change or other conditions change, it could result in a sale that is less favorable to us than initially assumed, which would typically have a negative impact on our financial results.

Prior to originating or acquiring loans or other assets for sale, we may undertake underwriting and due diligence efforts with respect to various aspects of the loan or asset. When underwriting or conducting due diligence, we rely on resources and data available to us, which may be limited, and we rely on investigations by third parties. We may also only conduct due diligence on a sample of a pool of loans or assets we are acquiring and assume that the sample is representative of the entire pool. Our underwriting and due diligence efforts may not reveal matters which could lead to losses. If our underwriting process is not robust enough or if we do not conduct adequate due diligence, or the scope of our underwriting or due diligence is limited, we may incur losses. Losses could occur due to the fact that a counterparty that sold us a loan or other asset (or that is the obligor or a party related to an obligor of a commercial loan we originate) refuses or is unable (e.g., due to its financial condition) to repurchase that loan or asset or pay damages to us if we determine subsequent to purchase that one or more of the representations or warranties made to us in connection with the sale or origination was inaccurate.

In addition, when selling commercial or residential mortgage loans or acquiring servicing rights associated with residential mortgage loans, we typically make representations and warranties to the purchaser or to other third parties regarding, among other things, certain characteristics of those assets, including characteristics we seek to verify through our underwriting and due diligence efforts. If our representations and warranties are inaccurate with respect to any asset, we may be obligated to repurchase that asset or pay damages, which may result in a loss. We generally only establish reserves for potential liabilities relating to representations and warranties we make if we believe that those liabilities are both probable and estimable, as determined in accordance with GAAP. As a result, we may not have reserves relating to these potential liabilities or any reserves we may establish could be inadequate. Even if we obtain

representations and warranties from the counterparties from whom we acquired the loans or other assets, they may not parallel the representations and warranties we make or may otherwise not protect us from losses, including, for example, due to the fact that the counterparty may be insolvent or otherwise unable to make a payment to us at the time we claim damages for a breach of representation or warranty. Furthermore, to the extent we claim that counterparties we have acquired loans from have breached their representations and warranties to us, it may adversely impact our business relationship with those counterparties, including by reducing the volume of business we conduct with those counterparties, which could negatively impact our ability to acquire loans and our business. To the extent we have significant exposure to representations and warranties made to us by one or more counterparties we acquire loans from, we may determine, as a matter of risk management, to reduce or discontinue loan acquisitions from those counterparties, which could reduce the volume of residential loans we acquire and negatively impact our business and financial results.

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Through certain of our wholly-owned subsidiaries we have engaged in the past, and continue to engage in, securitization transactions relating to residential mortgage loans. We have in the past also engaged in, and may in the future engage in, other types of securitization transactions or similar transactions, including securitization transactions relating to commercial real estate loans and other types of commercial real estate investments. In addition, we have invested in and continue to invest in mortgage-backed securities and other ABS issued in securitization transactions sponsored by other companies. These types of transactions and investments expose us to potentially material risks.

Engaging in securitization transactions and other similar transactions generally requires us to incur short-term debt, either on a recourse or non-recourse basis, to finance the accumulation of loans or other assets prior to securitization. In addition, in connection with engaging in securitization transactions, we engage in due diligence with respect to the loans or other assets we are securitizing and make representations and warranties relating to those loans and assets. The risks associated with incurring this type of debt in connection with securitization activity and the risks associated with the due diligence we conduct, and the representations and warranties we make, in connection with securitization activity are similar to the risks associated with acquiring and originating loans with the intent to sell them to third parties, as described in the immediately preceding risk factor titled *Through certain of our wholly-owned subsidiaries we have engaged in the past, and plan to continue to engage, in acquiring residential mortgage loans and originating commercial mortgage loans with the intent to sell these loans to third parties or hold them as investments. Similarly, we have engaged in the past, and plan to continue to engage, in acquiring servicing rights associated with residential mortgage loans. These types of transactions and investments expose us to potentially material risks.*

When engaging in securitization transactions, we also prepare marketing and disclosure documentation, including term sheets and prospectuses, that include disclosures regarding the securitization transactions and the assets being securitized. If our marketing and disclosure documentation are alleged or found to contain inaccuracies or omissions, we may be liable under federal and state securities laws (or under other laws) for damages to third parties that invest in these securitization transactions, including in circumstances where we relied on a third party in preparing accurate disclosures, or we may incur other expenses and costs in connection with disputing these allegations or settling claims. We may also sell or contribute commercial real estate loans to third parties who, in turn, securitize those loans. In these circumstances, we may also prepare marketing and disclosure documentation, including documentation that is included in term sheets and prospectuses relating to those securitization transactions. We could be liable under federal and state securities laws (or under other laws) for damages to third parties that invest in these securitization transactions, including liability for disclosures prepared by third parties or with respect to loans that we did not sell or contribute to the securitization.

In recent years there has also been debate as to whether there are defects in the legal process and legal documents governing transactions in which securitization trusts and other secondary purchasers take legal ownership of residential mortgage loans and establish their rights as first priority lien holders on underlying mortgaged property. To the extent there are problems with the manner in which title and lien priority rights were established or transferred, securitization transactions that we sponsored and third-party sponsored securitizations that we hold investments in may experience losses, which could expose us to losses and could damage our ability to engage in future securitization transactions.

In connection with our operating and investment activity, we rely on third parties to perform certain services, comply with applicable laws and regulations, and carry out contractual covenants and terms, the failure of which by any of these third parties may adversely impact our business and financial results.

In connection with our business of acquiring and originating loans, engaging in securitization transactions, and investing in third-party issued securities and other assets, we rely on third party service providers to perform certain services, comply with applicable laws and regulations, and carry out contractual covenants and terms. As a result, we are subject to the risks associated with a third party's failure to perform, including failure to perform due to reasons such as fraud, negligence, errors, miscalculations, or insolvency. For example, many loan servicers are experiencing higher volumes of delinquent loans than they have in the past and, as a result, there is a risk that their operational infrastructures cannot properly process this increased volume. Many loan servicers have been accused of improprieties in the handling of the foreclosure process with respect to residential mortgage loans that have gone into default. To the extent a third party loan servicer fails to fully and properly perform its obligations, loans and securities that we hold as investments may experience losses and securitizations that we have sponsored may experience poor performance, and our ability to engage in future securitization transactions could be harmed.

For some of the loans that we hold and for some of the loans we sell or securitize, we hold the right to service those loans and we retain a sub-servicer to service those loans. In these circumstances we are exposed to certain risks, including, without limitation, that we may not be able to enter into subservicing agreements on favorable terms to us or at all, or that the sub-servicer may not properly service the loan in compliance with applicable laws and regulations or the contractual provisions governing their sub-servicing role, and that we would be held liable for the sub-servicer's improper acts or omissions. In addition, in these circumstances we are

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obligated to fund any obligation of the sub-servicer to make advances on behalf of a delinquent loan obligor. We have generally used only one sub-servicer counterparty and, as a result, the risks associated with our use of a sub-servicer have been concentrated around this single sub-servicer counterparty. To the extent that there are significant amounts of advances that need to be funded in respect of loans where we own the servicing right, it could have a material adverse effect on our business and financial results.

We also rely on corporate trustees to act on behalf of us and other holders of ABS in enforcing our rights as security holders. Under the terms of most ABS we hold, we do not have the right to directly enforce remedies against the issuer of the security, but instead must rely on a trustee to act on behalf of us and other security holders. Should a trustee not be required to take action under the terms of the securities, or fail to take action, we could experience losses. In the context of our commercial mortgage banking and investment activities, we rely on third parties to manage and operate the properties that directly or indirectly collateralize our commercial loans, to generate operating results and cash flow sufficient to service our loans and support the repayment or refinancing of our loans at maturity, and to mitigate the risk of losses.

Our ability to execute or participate in future securitization transactions, including, in particular, securitizations of residential mortgage loans, could be delayed, limited, or precluded by legislative and regulatory reforms applicable to asset-backed securities and the institutions that sponsor, service, rate, or otherwise participate in or contribute to the successful execution of a securitization transaction. Other factors could also limit, delay, or preclude our ability to execute securitization transactions. These legislative, regulatory, and other factors could also reduce the returns we would otherwise expect to earn in connection with executing securitization transactions.

In July 2010, the Dodd-Frank Act was enacted. Provisions of the Dodd-Frank Act require, among other things, significant revisions to the legal and regulatory framework under which ABS, including residential mortgage-backed securities (RMBS), are issued through the execution of securitization transactions. Some of the provisions of the Dodd-Frank Act have become effective or been implemented, while others are in the process of being implemented or will become effective soon. In addition, prior to the passage of the Dodd-Frank Act, the Securities and Exchange Commission (SEC) and the Federal Deposit Insurance Corporation had already published proposed and final regulations under already existing legislative authority relating to the issuance of ABS, including RMBS. Additional federal or state laws and regulations that could affect our ability to execute future securitization transactions could be proposed, enacted, or implemented. In addition, various federal and state agencies and law enforcement authorities, as well as private litigants, have initiated and may, in the future, initiate additional broad-based enforcement actions or claims, the resolution of which may include industry-wide changes to the way residential mortgage loans are originated, transferred, serviced, and securitized, and any of these changes could also affect our ability to execute future securitization transactions. For an example, please refer to the risk factor titled *Federal and state legislative and regulatory developments and the actions of governmental authorities and entities may adversely affect our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future.* for a description of the settlement of a recent enforcement action that resulted in changes to mortgage loan servicing standards and a description of regulations relating to residential mortgage origination recently promulgated by the CFPB.

It is difficult to predict with certainty how the Dodd-Frank Act and the other regulations that have been proposed, finalized, or recently implemented will affect our future ability to successfully execute or participate in securitization transactions, due to, among other things, the fact that federal agencies have not yet finalized or fully implemented all of the regulations implementing the Dodd-Frank Act. In addition, recently finalized truth-in-lending regulations include provisions under which the purchaser (and assignee) of a residential mortgage loan is liable for regulatory

violations by the originator of the loan. These laws, regulations, and enforcement actions and private litigation settlements could effectively preclude us from executing securitization transactions, delay our execution of these types of transactions, or reduce the returns we would otherwise expect to earn from executing securitization transactions.

Rating agencies can affect our ability to execute or participate in a securitization transaction, or reduce the returns we would otherwise expect to earn from executing securitization transactions, not only by deciding not to publish ratings for our securitization transactions (or deciding not to consent to the inclusion of those ratings in the prospectuses or other documents we file with the SEC relating to securitization transactions), but also by altering the criteria and process they follow in publishing ratings. Rating agencies could alter their ratings processes or criteria after we have accumulated loans or other assets for securitization in a manner that effectively reduces the value of those previously acquired loans or requires that we incur additional costs to comply with those processes and criteria. For example, to the extent investors in a securitization transaction would have significant exposure to representations and warranties made by us or by one or more counterparties we acquire loans from, rating agencies may determine that this exposure increases investment risks relating to the securitization transaction. Rating agencies could reach this conclusion either because of our financial condition or the financial condition of one or more counterparties we acquire loans from, or because of the aggregate amount of residential loan-related representations and warranties (or other contingent liabilities) we, or one or more

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counterparties we acquire loans from, have made or have exposure to. If, as a result, rating agencies place limitations on our ability to execute future securitization transactions or impose unfavorable ratings levels or conditions on our securitization transactions, it could reduce the returns we would otherwise expect to earn from executing these transactions and negatively impact our business and financial results. In addition, the actual short- and long-term impact on our ability to securitize residential mortgage loans in the future will depend, in large part, on how the rating agencies assess the investment risks that result from the ability-to-repay regulations recently promulgated by the CFPB, including, for example, how they assess investment risks associated with residential mortgage loans that have an interest-only payment feature or loans under which the borrower has a debt-to-income ratio of more than 43% (as these types of loans have historically accounted for a significant amount of the loans we have securitized, but they will not be considered qualified mortgages under the ability-to-repay regulations).

Furthermore, other matters, such as (i) accounting standards applicable to securitization transactions and (ii) capital and leverage requirements applicable to banks and other regulated financial institutions' holdings of ABS, could result in less investor demand for securities issued through securitization transactions we execute or increased competition from other institutions that originate, acquire, and hold commercial real estate loans, residential mortgage loans, and other types of assets and execute securitization transactions.

Our ability to profitably execute or participate in future securitizations transactions, including, in particular, securitizations of residential mortgage loans, is dependent on numerous factors and if we are not able to achieve our desired level of profitability or if we incur losses in connection with executing or participating in future securitizations it could have a material adverse impact on our business and financial results.

There are a number of factors that can have a significant impact on whether a securitization transaction that we execute or participate in is profitable to us or results in a loss. One of these factors is the price we pay for (or cost of originating) the mortgage loans that we securitize, which, in the case of residential mortgage loans, is impacted by the level of competition in the marketplace for acquiring residential mortgage loans and the relative desirability to originators of retaining residential mortgage loans as investments or selling them to third parties such as us. Another factor that impacts the profitability of a securitization transaction is the cost to us of the short-term debt that we use to finance our holdings of mortgage loans prior to securitization, which cost is affected by a number of factors including the availability of this type of financing to us, the interest rate on this type of financing, the duration of the financing we incur, and the percentage of our mortgage loans for which third parties are willing to provide short-term financing.

After we acquire or originate mortgage loans that we intend to securitize, we can also suffer losses if the value of those loans declines prior to securitization. Declines in the value of a residential mortgage loan, for example, can be due to, among other things, changes in interest rates, changes in the credit quality of the loan, and changes in the projected yields required by investors to invest in securitization transactions. To the extent we seek to hedge against a decline in loan value due to changes in interest rates, there is a cost of hedging that also affects whether a securitization is profitable. Other factors that can significantly affect whether a securitization transaction is profitable to us include the criteria and conditions that rating agencies apply and require when they assign ratings to the mortgage-backed securities issued in our securitization transactions, including the percentage of mortgage-backed securities issued in a securitization transaction that the rating agencies will assign a triple-A rating to, which, in the case of residential mortgage loans is also referred to as a rating agency subordination level. Rating agency subordination levels can be impacted by numerous factors, including, without limitation, the credit quality of the loans securitized, the geographic distribution of the loans to be securitized, and the structure of the securitization transaction and other applicable rating agency criteria. All other factors being equal, the greater the percentage of the mortgage-backed securities issued in a securitization transaction that the rating agencies will assign a triple-A rating

to, the more profitable the transaction will be to us.

The price that investors in mortgage-backed securities will pay for securities issued in our securitization transactions also has a significant impact on the profitability of the transactions to us, and these prices are impacted by numerous market forces and factors. In addition, the underwriter(s) or placement agent(s) we select for securitization transactions, and the terms of their engagement, can also impact the profitability of our securitization transactions. Also, transaction costs incurred in executing transactions impact the profitability of our securitization transactions and any liability that we may incur, or may be required to reserve for, in connection with executing a transaction can cause a loss to us. To the extent that we are not able to profitably execute future securitizations of residential mortgage loans or other assets, including for the reasons described above or for other reasons, it could have a material adverse impact on our business and financial results.

Our past and future securitization activities or other past and future business or operating activities or practices could expose us to litigation, which may adversely affect our business and financial results.

Through certain of our wholly-owned subsidiaries we have in the past engaged in or participated in securitization transactions relating to residential mortgage loans, commercial mortgage loans, commercial real estate loans, and other types of assets. In the

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future we expect to continue to engage in or participate in securitization transactions, including, in particular, securitization transactions relating to residential mortgage loans and commercial mortgage loans, and may also engage in other types of securitization transactions or similar transactions. Sequoia securitization entities we sponsored issued ABS backed by residential mortgage loans held by these Sequoia entities. In Acacia securitization transactions we participated in, Acacia securitization entities issued ABS backed by securities and other assets held by these Acacia entities. As a result of declining property values, increasing defaults, changes in interest rates, and other factors, the aggregate cash flows from the loans held by the Sequoia entities and the securities and other assets held by the Acacia entities may be insufficient to repay in full the principal amount of ABS issued by these securitization entities. We are not directly liable for any of the ABS issued by these entities. Nonetheless, third parties who hold the ABS issued by these entities may try to hold us liable for any losses they experience, including through claims under federal and state securities laws or claims for breaches of representations and warranties we made in connection with engaging in these securitization transactions.

For example, as discussed below in Part I, Item 3 of this Annual Report on Form 10-K, on October 15, 2010, the Federal Home Loan Bank of Chicago filed a claim in the Circuit Court of Cook County, Illinois against us and our subsidiary, Sequoia Residential Funding, Inc. The complaint relates in part to residential mortgage-backed securities that were issued by a Sequoia securitization entity and alleges that, at the time of issuance, we, Sequoia Residential Funding, Inc. and the underwriters made various misstatements and omissions about these securities in violation of Illinois state law. We have also been named in other similar lawsuits. A further discussion of these lawsuits is set forth in *Note 15* to the Financial Statements within this Annual Report on Form 10-K.

Other aspects of our business operations or practices could also expose us to litigation. In the ordinary course of our business we enter into agreements relating to, among other things, loans we acquire and investments we make, assets and loans we sell, financing transactions, third parties we retain to provide us with goods and services, and our leased office space. We also regularly enter into confidentiality agreements with third parties under which we receive confidential information. If we breach any of these agreements, we could be subject to claims for damages and related litigation. We are also subject to various laws and regulations relating to our business and operations, including, without limitation, privacy laws and regulations and labor and employment laws and regulations, and if we fail to comply with these laws and regulations we could also be subjected to claims for damages and litigation. In particular, if we fail to maintain the confidentiality of consumers' personal or financial information we obtain in the course of our business (such as social security numbers), we could be exposed to losses.

Defending a lawsuit can consume significant resources and may divert management's attention from our operations. We may be required to establish or increase reserves for potential losses from litigation, which could be material. To the extent we are unsuccessful in our defense of any lawsuit, we could suffer losses which could be in excess of any reserves established relating to that lawsuit) and these losses could be material.

Our cash balances and cash flows may be insufficient relative to our cash needs.

We need cash to make interest payments, to post as collateral to counterparties and lenders who provide us with short-term debt financing and who engage in other transactions with us, for working capital, to fund REIT dividend distribution requirements, to comply with financial covenants and regulatory requirements, and for other needs and purposes. We may also need cash to repay short-term borrowings when due or in the event the fair values of assets that serve as collateral for that debt decline, the terms of short-term debt become less attractive, or for other reasons. In addition, we may need to use cash to post in response to margin calls relating to various derivative instruments we hold as the values of these derivatives change.

Our sources of cash flow include the principal and interest payments on the loans and securities we own, asset sales, securitizations, short-term borrowing, issuing long-term debt, and issuing stock. Our sources of cash may not be sufficient to satisfy our cash needs. Cash flows from principal repayments could be reduced if prepayments slow or if credit quality deteriorates. For example, for some of our assets, cash flows are locked-out and we receive less than our pro-rata share of principal payment cash flows in the early years of the investment.

Our minimum dividend distribution requirements could exceed our cash flows if our income as calculated for tax purposes significantly exceeds our net cash flows. This could occur when taxable income (including non-cash income such as discount amortization and interest accrued on negative amortizing loans) exceeds cash flows received. The Internal Revenue Code provides a limited relief provision concerning certain items of non-cash income; however, this provision may not sufficiently reduce our cash dividend distribution requirement. In the event that our liquidity needs exceed our access to liquidity, we may need to sell assets at an inopportune time, thus reducing our earnings. In an adverse cash flow situation, we may not be able to sell assets effectively and our REIT status or our solvency could be threatened. Further discussion of the risk associated with maintaining our REIT status is set forth

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in the risk factor titled *Redwood has elected to be a REIT and, as such, is required to meet certain tests in order to maintain its REIT status. This adds complexity and costs to running our business and exposes us to additional risks.*

We are subject to competition and we may not compete successfully.

We are subject to competition in seeking investments, originating commercial loans, acquiring and selling residential loans, engaging in securitization transactions, and in other aspects of our business. Our competitors include commercial banks, other mortgage REITs, Fannie Mae, Freddie Mac, regional and community banks, broker-dealers, insurance companies, and other financial institutions, as well as investment funds and other investors in real estate-related assets. In addition, other companies may be formed that will compete with us. Some of our competitors have greater resources than us and we may not be able to compete successfully with them. Furthermore, competition for investments, making loans, acquiring and selling loans, and engaging in securitization transactions may lead to a decrease in the opportunities and returns available to us.

In addition, there are significant competitive threats to our business from governmental actions and initiatives that have already been undertaken or which may be undertaken in the future. Sustained competition from governmental actions and initiatives could have a material adverse effect on us. For example, Fannie Mae and Freddie Mac are, among other things, engaged in the business of acquiring loans and engaging in securitization transactions. Until 2008, competition from Fannie Mae and Freddie Mac was limited to some extent due to the fact that they were statutorily prohibited from purchasing loans for single unit residences in the continental United States with a principal amount in excess of \$417,000, while much of our business had historically focused on acquiring residential loans with a principal amount in excess of \$417,000. In February 2008, Congress passed an economic stimulus package that temporarily increased the size of certain loans these entities could purchase to up to \$729,750, if the loans were made to secure real estate purchases in certain high-cost areas of the U.S. As of December 31, 2013, this \$729,750 loan size limit had been reduced to \$625,500, which is an amount that continues to be above the historical \$417,000 loan size limit. In addition, in September 2008, Fannie Mae and Freddie Mac were placed into conservatorship and have become, in effect, instruments of the U.S. federal government. As long as there is governmental support for these entities to continue to operate and provide financing to a significant portion of the mortgage finance market, they will represent significant business competition due to, among other things, their large size and low cost of funding.

To the extent that laws, regulations, or policies governing the business activities of Fannie Mae and Freddie Mac are not further changed to limit their role in housing finance (such as a change in these loan size limits or in the guarantee fees they charge), the competition from these two governmental entities will remain significant. In addition, to the extent that property values decline while these loan size limits remain the same, it may have the same effect as an increase in this limit, as a greater percentage of loans would likely be within the size limit. Any increase in the loan size limit, or in the overall percentage of loans that are within the limit, allows Fannie Mae and Freddie Mac to compete against us to a greater extent than they had been able to compete previously and our business could be adversely affected.

Our business model and business strategies, and the actions we take (or fail to take) to implement them and adapt them to changing circumstances involve risk and may not be successful.

Due to the recent financial crisis and downturn in the U.S. real estate markets and the economy, the mortgage industry and the related capital markets are still undergoing significant changes, including due to the significant governmental interventions in these areas and changes to the laws and regulations that govern the banking and mortgage finance industry. Our methods of, and model for, doing business and financing our investments are changing and if we fail to

develop, enhance, and implement strategies to adapt to changing conditions in the mortgage industry and capital markets, our business and financial results may be adversely affected. Furthermore, changes we make to our business to respond to changing circumstances may expose us to new or different risks than we were previously exposed to and we may not effectively identify or manage those risks.

Similarly, the competitive landscape in which we operate and the products and investments for which we compete are also affected by changing conditions. There may be trends or sudden changes in our industry or regulatory environment, changes in the role of government-sponsored entities, such as Fannie Mae and Freddie Mac, changes in the role of credit rating agencies or their rating criteria or processes, or changes in the U.S. economy more generally. If we do not effectively respond to these changes or if our strategies to respond to these changes are not successful, our ability to effectively compete in the marketplace may be negatively impacted, which would likely result in our business and financial results being adversely affected.

We have historically depended upon the issuance of mortgage-backed securities by the securitization entities we sponsor as a funding source for our residential real estate-related business. However, due to market conditions, we did not engage in residential mortgage securitization transactions in 2008 or 2009 and we only engaged in one residential mortgage securitization transaction in

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2010 and two residential mortgage securitization transactions in 2011. While we engaged in numerous residential mortgage securitization transactions over the course of 2012 and 2013, we do not know if market conditions will allow us to continue to regularly engage in these types of securitization transactions and any disruption of this market may adversely affect our earnings and growth. For example, in the second half of 2013, we completed four securitization transactions, as compared to eight securitizations in the first half of 2013, representing a trend that has continued into the first quarter of 2014. Even if regular residential mortgage securitization activity continues among market participants other than government-sponsored entities, we do not know if it will continue to be on terms and conditions that will permit us to participate or be favorable to us. Even if conditions are favorable to us, we may not be able to return to or sustain the volume of securitization activity we previously conducted.

Similarly, our commercial lending platform relies on a healthy and active commercial mortgage securitization market in order to provide a source of financing for commercial mortgage loans we originate. We do not know if market conditions in commercial mortgage securitization markets will allow us to continue to regularly participate in these types of securitization transactions and any disruption of this market may also adversely affect our earnings and growth. Even if regular commercial mortgage securitization activity continues among market participants, we do not know if it will continue to be on terms and conditions that will permit us to participate or be favorable to us.

Initiating new business activities or significantly expanding existing business activities may expose us to new risks and will increase our cost of doing business.

Initiating new business activities or significantly expanding existing business activities are two ways to grow our business and respond to changing circumstances in our industry; however, they may expose us to new risks and regulatory compliance requirements. We cannot be certain that we will be able to manage these risks and compliance requirements effectively. Furthermore, our efforts may not succeed and any revenues we earn from any new or expanded business initiative may not be sufficient to offset the initial and ongoing costs of that initiative, which would result in a loss with respect to that initiative. For example, efforts we have made and continue to make to significantly expand our investing activity in commercial real-estate related assets and to develop new methods and channels for acquiring, securitizing, and selling residential and commercial real estate-related investment assets may expose us to new risks, may not succeed, and may not generate sufficient revenue to offset our related costs. We have also engaged in increasing our holdings of residential MSR, and we recently began acquiring residential mortgage loans for sale to Fannie Mae and Freddie Mac, which enables us to create our own investments in MSR and positions us to be involved in risk-sharing opportunities at the originator level to the extent those opportunities arise in the future, but these efforts could expose us to new risks or not succeed, and may not generate sufficient revenue to offset our related costs.

In connection with initiating new business activities or expanding existing business activities, or for other business reasons, we may create new subsidiaries. Generally, these subsidiaries would be wholly-owned, directly or indirectly, by Redwood. The creation of those subsidiaries may increase our administrative costs and expose us to other legal and reporting obligations, including, for example, because they may be incorporated in states other than Maryland or may be established in a foreign jurisdiction. Any new subsidiary we create may be designated as a taxable subsidiary. Taxable subsidiaries are wholly-owned subsidiaries of a REIT that pay corporate income tax on the income they generate. That is, a taxable subsidiary is not able to deduct its dividends paid to its parent in determining its taxable income and any dividends paid to the parent are generally recognized as income at the parent level.

Our future success depends on our ability to attract and retain key personnel.

Our future success depends on the continued service and availability of skilled personnel, including members of our executive management team such as our Chief Executive Officer, our President, our Chief Investment Officer, our Chief Financial Officer, and our General Counsel. To the extent personnel we attempt to hire are concerned that economic, regulatory, or other factors could impact our ability to maintain or expand our current level of business, it could negatively impact our ability to hire the personnel we need to operate our business. We cannot assure you that we will be able to attract and retain key personnel.

We may not be able to obtain or maintain the governmental licenses required to operate our business and we may fail to comply with various state and federal laws and regulations applicable to our business of acquiring residential mortgage loans and servicing rights and originating commercial real estate loans. We are a seller/servicer approved to sell residential mortgage loans to Freddie Mac and Fannie Mae and failure to maintain our status as an approved seller/servicer could harm our business.

While we are not required to obtain licenses to purchase mortgage-backed securities, the purchase of residential mortgage loans in the secondary market may, in some circumstances, require us to maintain various state licenses. Acquiring the right to service residential mortgage loans may also, in some circumstances, require us to maintain various state licenses even though we currently do not expect to directly engage in loan servicing ourselves. Similarly, certain commercial real estate lending activities that we engage in

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also require us to obtain and maintain various state licenses. As a result, we could be delayed in conducting certain business if we were first required to obtain a state license. We cannot assure you that we will be able to obtain all of the licenses we need or that we would not experience significant delays in obtaining these licenses. Furthermore, once licenses are issued we are required to comply with various information reporting and other regulatory requirements to maintain those licenses, and there is no assurance that we will be able to satisfy those requirements or other regulatory requirements applicable to our business of acquiring residential mortgage loans on an ongoing basis. Our failure to obtain or maintain required licenses or our failure to comply with regulatory requirements that are applicable to our business of acquiring residential mortgage loans or originating commercial loans may restrict our business and investment options and could harm our business and expose us to penalties or other claims.

For example, under the Dodd-Frank Act, the CFPB also has regulatory authority over certain aspects of our business as a result of our residential mortgage banking activities, including, without limitation, authority to bring an enforcement action against us for failure to comply with regulations promulgated by the Bureau that are applicable to our business. One of the Bureau's areas of focus has been on whether companies like us take appropriate steps to ensure that business arrangements with service providers do not present risks to consumers. The sub-servicer we retain to directly service residential mortgage loans (when we own the associated MSR) is one of our most significant service providers with respect to our residential mortgage banking activities and our failure to take steps to ensure that this sub-servicer is servicing these residential mortgage loans in accordance with applicable law and regulation could result in enforcement action by the Bureau against us that could restrict our business, expose us to penalties or other claims, negatively impact our financial results, and damage our reputation.

In addition, we are a seller/servicer approved to sell residential mortgage loans to Freddie Mac and Fannie Mae. As an approved seller/servicer, we are required to conduct certain aspects of our operations in accordance with applicable policies and guidelines published by Freddie Mac and Fannie Mae and we are required to pledge a certain amount of cash to Freddie Mac and Fannie Mae to collateralize potential obligations to Freddie Mac and Fannie Mae. Failure to maintain our status as an approved seller/servicer would mean we would not be able to sell mortgage loans to these entities, could result in our being required to repurchase loans previously sold to these entities, or could otherwise restrict our business and investment options and could harm our business and expose us to losses or other claims. Fannie Mae or Freddie Mac may, in the future, require us to hold additional capital or pledge additional cash or assets in order to obtain or maintain approved seller/servicer status, which, if required, could adversely impact our financial results.

With respect to mortgage loans we own, or which we have purchased and subsequently sold, we may be subject to liability for potential violations of truth-in-lending or other similar consumer protection laws and regulations, which could adversely impact our business and financial results.

Federal consumer protection laws and regulations have been enacted and promulgated that are designed to regulate residential mortgage loan underwriting and originators' lending processes, standards, and disclosures to borrowers. These laws and regulations include the CFPB's ability-to-repay and qualified mortgage regulations. In addition, there are various other federal, state, and local laws and regulations that are intended to discourage predatory lending practices by residential mortgage loan originators. For example, the federal Home Ownership and Equity Protection Act of 1994 (HOEPA) prohibits inclusion of certain provisions in residential mortgage loans that have mortgage rates or origination costs in excess of prescribed levels and requires that borrowers be given certain disclosures prior to origination. Some states have enacted, or may enact, similar laws or regulations, which in some cases may impose restrictions and requirements greater than those in place under federal laws and regulations. In addition, under the anti-predatory lending laws of some states, the origination of certain residential mortgage loans, including loans that

are classified as high cost loans under applicable law, must satisfy a net tangible benefits test with respect to the borrower. This test, as well as certain standards set forth in the ability-to-repay and qualified mortgage regulations, may be highly subjective and open to interpretation. As a result, a court may determine that a residential mortgage loan did not meet the standard or test even if the originator reasonably believed such standard or test had been satisfied. Failure of residential mortgage loan originators or servicers to comply with these laws and regulations could subject us, as an assignee or purchaser of these loans (or as an investor in securities backed by these loans), to monetary penalties and defenses to foreclosure, including by recoupment or setoff of finance charges and fees collected, and could result in rescission of the affected residential mortgage loans, which could adversely impact our business and financial results.

Environmental protection laws that apply to properties that secure or underlie our loan and investment portfolio could result in losses to us. We may also be exposed to environmental liabilities with respect to properties we become direct or indirect owners of or to which we take title, which could adversely affect our business and financial results.

Under the laws of several states, contamination of a property may give rise to a lien on the property to secure recovery of the cleanup costs. In certain of these states, such a lien has priority over the lien of an existing mortgage against the property, which could

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impair the value of an investment in a security we own backed by such a property or could reduce the value of such a property that underlies loans we have made or own. In addition, under the laws of some states and under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1980, we may be liable for costs of addressing releases or threatened releases of hazardous substances that require remedy at a property securing or underlying a loan we hold if our agents or employees have become sufficiently involved in the hazardous waste aspects of the operations of the borrower of that loan, regardless of whether or not the environmental damage or threat was caused by us or the borrower.

In the course of our business, we may take title to residential or commercial real estate or may otherwise become direct or indirect owners of real estate. If we do take title or become a direct or indirect owner, we could be subject to environmental liabilities with respect to the property, including liability to a governmental entity or third parties for property damage, personal injury, investigation, and clean-up costs. In addition, we may be required to investigate or clean up hazardous or toxic substances or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. If we ever become subject to significant environmental liabilities, our business and financial results could be materially and adversely affected.

Our technology infrastructure and systems are important and any significant disruption or breach of the security of this infrastructure or these systems could have an adverse effect on our business. We also rely on technology infrastructure and systems of third parties who provide services to us and with whom we transact business.

In order to analyze, acquire, and manage our investments, manage the operations and risks associated with our business, assets, and liabilities, and prepare our financial statements we rely upon computer hardware and software systems. Some of these systems are located at our offices and some are maintained by third party vendors or located at facilities maintained by third parties. We also rely on technology infrastructure and systems of third parties who provide services to us and with whom we transact business. Any significant interruption in the availability or functionality of these systems could impair our access to liquidity, damage our reputation, and have an adverse effect on our operations and on our ability to timely and accurately report our financial results.

In addition, any breach of the security of these systems could have an adverse effect on our operations and the preparation of our financial statements. Steps we have taken to provide for the security of our systems and data may not effectively prevent others from obtaining improper access to our systems data. Improper access could expose us to risks of data loss, reputational damage, increased regulatory scrutiny, litigation, and liabilities to third parties, and otherwise disrupt our operations. For example, our systems and the systems of third parties who provide services to us and with whom we transact business may contain non-public personal information that an identity thief could utilize in engaging in fraudulent activity or theft. We may be liable for losses suffered by individuals whose identities are stolen as a result of a breach of the security of these systems, and any such liability could be material.

Our business could be adversely affected by deficiencies in our disclosure controls and procedures or internal controls over financial reporting.

The design and effectiveness of our disclosure controls and procedures and internal controls over financial reporting may not prevent all errors, misstatements, or misrepresentations. While management continues to review the effectiveness of our disclosure controls and procedures and internal controls over financial reporting, there can be no assurance that our disclosure controls and procedures or internal controls over financial reporting will be effective in accomplishing all control objectives all of the time. Deficiencies, particularly material weaknesses or significant deficiencies, in internal controls over financial reporting which have occurred or which may occur in the future could

result in misstatements of our financial results, restatements of our financial statements, a decline in our stock price, or an otherwise material and adverse effect on our business, reputation, financial results, or liquidity and could cause investors and creditors to lose confidence in our reported financial results.

Our risk management efforts may not be effective.

We could incur substantial losses and our business operations could be disrupted if we are unable to effectively identify, manage, monitor, and mitigate financial risks, such as credit risk, interest rate risk, prepayment risk, liquidity risk, and other market-related risks, as well as operational risks related to our business, assets, and liabilities. Our risk management policies, procedures, and techniques may not be sufficient to identify all of the risks we are exposed to, mitigate the risks we have identified, or to identify additional risks to which we may become subject in the future. Expansion of our business activities may also result in our being exposed to risks that we have not previously been exposed to or may increase our exposure to certain types of risks and we may not effectively identify, manage, monitor, and mitigate these risks as our business activity changes or increases.

Some of our risk management efforts are carried out by entering into interest rate agreements and other derivatives intended to hedge against certain interest rate and other financial risks. These derivatives are generally entered into under agreements in which we

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make various representations and warranties and covenants and which contain various events of default or termination events. If we breach these agreements or if they otherwise terminate, we may suffer losses and we may, thereafter, not be hedged against certain financial risks that we had intended to hedge against. In addition, if we breach these agreements or they otherwise terminate, the circumstances that resulted in the breach or termination, or other circumstances, may prevent us from using other similar agreements that are already in place or from entering into replacement agreements to hedge against financial risk.

We could be harmed by misconduct or fraud that is difficult to detect.

We are exposed to risks relating to misconduct by our employees, contractors we use, or other third parties with whom we have relationships. For example, our employees could execute unauthorized transactions, use our assets improperly or without authorization, perform improper activities, use confidential information for improper purposes, or mis-record or otherwise try to hide improper activities from us. This type of misconduct could also relate to assets we manage for others through our investment advisory subsidiary. This type of misconduct can be difficult to detect and if not prevented or detected could result in claims or enforcement actions against us or losses. Accordingly, misconduct by employees, contractors, or others could subject us to losses or regulatory sanctions and seriously harm our reputation. Our controls may not be effective in detecting this type of activity.

Inadvertent errors, including, for example, errors in the implementation of information technology systems, could subject us to financial loss, litigation, or regulatory action.

Our employees, contractors we use, or other third parties with whom we have relationships may make inadvertent errors that could subject us to financial losses, claims, or enforcement actions. These types of errors could include, but are not limited to, mistakes in executing, recording, or reporting transactions we enter into for ourselves or with respect to assets we manage for others. Errors in the implementation of information technology systems or other operational systems and procedures could also interrupt our business or subject us to financial losses, claims, or enforcement actions. Inadvertent errors expose us to the risk of material losses until the errors are detected and remedied prior to the incurrence of any loss. The risk of errors may be greater for business activities that are new for us or have non-standardized terms, for areas of our business that we are expanding, or for areas of our business that rely on new employees or on third parties that we have only recently established relationships with.

Our business may be adversely affected if our reputation is harmed.

Our business is subject to significant reputational risks. If we fail, or appear to fail, to address various issues that may affect our reputation, our business could be harmed. Issues could include real or perceived legal or regulatory violations or be the result of a failure in governance, risk-management, technology, or operations. Similarly, market rumors and actual or perceived association with counterparties whose own reputation is under question could harm our business. Lawsuits brought against us (or the resolution of lawsuits brought against us), claims of employee misconduct, claims of wrongful termination, adverse publicity, conflicts of interest, ethical issues, or failure to maintain the security of our information technology systems or to protect private information could also cause significant reputational damages. Such reputational damage could result not only in an immediate financial loss, but could also result in a loss of business relationships, the ability to raise capital, and the ability to access liquidity through borrowing facilities.

Our financial results are determined and reported in accordance with generally accepted accounting principles (and related conventions and interpretations), or GAAP, and are based on estimates and assumptions made in

accordance with those principles, conventions, and interpretations. Furthermore, the amount of dividends we are required to distribute as a REIT is driven by the determination of our income in accordance with the Internal Revenue Code rather than generally accepted accounting principles.

Our reported GAAP financial results differ from the taxable income results that drive our dividend distribution requirements and, therefore, our GAAP results may not be an accurate indicator of taxable income and dividend distributions.

Generally, the cumulative income we report relating to an investment asset will be the same for GAAP and tax purposes, although the timing of this recognition over the life of the asset could be materially different. There are, however, certain permanent differences in the recognition of certain expenses under the respective accounting principles applied for GAAP and tax purposes and these differences could be material. Thus, the amount of GAAP earnings reported in any given period may not be indicative of future dividend distributions. A further explanation of differences between our GAAP and taxable income is presented in *Management's Discussion and Analysis of Financial Condition and Results of Operations*, which is set forth in Part II, Item 7 of this Annual Report on Form 10-K.

Our minimum dividend distribution requirements are determined under the REIT tax laws and are based on our taxable income as calculated for tax purposes pursuant to the Internal Revenue Code. Our Board of Directors may also decide to distribute more than is

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required based on these determinations. One should not expect that our retained GAAP earnings will equal cumulative distributions, as the Board of Directors' dividend distribution decisions, permanent differences in GAAP and tax accounting, and even temporary differences may result in material differences in these balances.

Over time, accounting principles, conventions, rules, and interpretations may change, which could affect our reported GAAP and taxable earnings and stockholders' equity.

Accounting rules for the various aspects of our business change from time to time. Changes in GAAP, or the accepted interpretation of these accounting principles, can affect our reported income, earnings, and stockholders' equity. In addition, changes in tax accounting rules or the interpretations thereof could affect our taxable income and our dividend distribution requirements. Predicting and planning for these changes can be difficult.

Redwood has elected to be a REIT and, as such, is required to meet certain tests in order to maintain its REIT status. This adds complexity and costs to running our business and exposes us to additional risks.

Failure to qualify as a REIT could adversely affect our net income and dividend distributions and could adversely affect the value of our common stock.

We have elected to qualify as a REIT for federal income tax purposes for all tax years since 1994. However, many of the requirements for qualification as a REIT are highly technical and complex and require an analysis of particular facts and an application of the legal requirements to those facts in situations where there is only limited judicial and administrative guidance. Thus, we cannot assure you that the Internal Revenue Service or a court would agree with our conclusion that we have qualified as a REIT historically, or that changes to our business or the law will not cause us to fail to qualify as a REIT in the future. Furthermore, in an environment where assets may quickly change in value, previous planning for compliance with REIT qualification rules may be disrupted. If we failed to qualify as a REIT for federal income tax purposes and did not meet the requirements for statutory relief, we would be subject to federal income tax at regular corporate rates on all of our income and we could possibly be disqualified as a REIT for four years thereafter. If we were to become subject to federal income tax, we might not have, at that time, the liquid assets to pay the taxes due, which could result in our liquidating assets at unattractive prices. Failure to qualify as a REIT could adversely affect our dividend distributions and could adversely affect the value of our common stock.

Maintaining REIT status and avoiding the generation of excess exclusion income at Redwood Trust, Inc. and certain of our subsidiaries may reduce our flexibility and could limit our ability to pursue certain opportunities. Failure to appropriately structure our business and transactions to comply with laws and regulations applicable to REITs could have adverse consequences.

To maintain REIT status, we must follow certain rules and meet certain tests. In doing so, our flexibility to manage our operations may be reduced. For instance:

Compliance with the REIT income and asset rules may limit the type or extent of financing or hedging that we can undertake.

Our ability to own non-real estate related assets and earn non-real estate related income is limited and the rules for classifying assets and income are complicated. For instance, compensation for performing mortgage origination and servicing activities does not constitute real estate income but income from an investment in, or financing of, excess MSR's may constitute real estate income under the rules applicable to REITs. Our ability to own equity interests in other entities is also limited. If we fail to comply with these limits, we may be forced to liquidate attractive investments on short notice on unfavorable terms in order to maintain our REIT status.

We generally use taxable subsidiaries to own non-real estate related assets and engage in activities that may give rise to non-real estate related income under the REIT rules. However, our ability to invest in taxable subsidiaries is limited under the REIT rules. Maintaining compliance with this limit could require us to constrain the growth of our TRS in the future.

Meeting minimum REIT dividend distribution requirements could reduce our liquidity. We may earn non-cash REIT taxable income due to timing and/or character mismatches between the computation of our income for tax and our book purposes. Earning non-cash REIT taxable income could necessitate our selling assets, incurring debt, or raising new equity in order to fund dividend distributions.

We could be viewed as a dealer with respect to certain transactions and become subject to a 100% prohibited transaction tax or other entity-level taxes on income from such transactions.

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Furthermore, the rules we must follow and the tests we must satisfy to maintain our REIT status may change, or the interpretation of these rules and tests by the Internal Revenue Service may change.

In addition, our stated goal has been to not generate excess inclusion income at Redwood Trust, Inc. and certain of its subsidiaries that would be taxable as unrelated business taxable income (UBTI) to our tax-exempt shareholders. Achieving this goal has limited, and may continue to limit, our flexibility in pursuing certain transactions or has resulted in, and may continue to result in, our having to pursue certain transactions through a taxable subsidiary, which reduces the net returns on these transactions by the associated tax liabilities. Despite our efforts to do so, we may not be able to avoid creating or distributing UBTI to our shareholders.

Changes in tax rules could adversely affect REITs and could adversely affect the value of our common stock.

The requirements for maintaining REIT status, the taxation of REITs and the taxation of mortgage related financial products could change in the future based on regulatory changes or tax legislation. Over the last year, Congressional subcommittees have been considering comprehensive tax reform proposals that would, among other things, overhaul the tax rules applicable to pass-through entities and financial products in connection with reducing rates of corporate taxation. The likelihood that comprehensive tax reform or other changes to tax laws or regulations will occur cannot be predicted. Any such future changes in the regulations or tax laws applicable to REITs or to mortgage related financial products could negatively impact our operations or reduce any competitive advantages we may have relative to non-REIT entities, either of which could reduce the value of our common stock.

The application of the tax code to our business is complicated and we may not interpret and apply some of the rules and regulations correctly. In addition, we may not make all available elections, which could result in our not being able to fully benefit from available deductions or benefits. Furthermore, the elections, interpretations and applications we do make could be deemed by the Internal Revenue Service (IRS) to be incorrect, and such rulings could have adverse impacts on our GAAP earnings and potentially on our REIT status.

The U.S. tax code may change and/or the interpretation of the rules and regulations by the IRS may change. In circumstances where the application of these rules and regulations affecting our business is not clear, we may have to interpret them and their application to us. We seek the advice of outside tax advisors in arriving at these interpretations, but our interpretations may prove to be wrong, which could have adverse consequences.

Our tax payments and dividend distributions, when based on required dividend distributions, are based in large part on our estimate of taxable income which includes the application and interpretation of a variety of tax rules and regulations. While there are some relief provisions should we incorrectly interpret certain rules and regulations, we may not be able to fully take advantage of these provisions and this could have an adverse effect on our REIT status. In addition, our GAAP earnings include tax provisions and benefits based on our estimates of taxable income and should our estimates prove to be wrong, we would have to make an adjustment to our taxable provisions and this adjustment could be material.

Our decisions about raising, managing, and distributing our capital may adversely affect our business and financial results. Furthermore, our growth may be limited if we are not able to raise additional capital.

We are required to distribute at least 90% of our REIT taxable income as dividends to shareholders. Thus, we do not generally have the ability to retain all of the earnings generated by our REIT and, to a large extent, we rely on our ability to raise capital to grow. We may raise capital through the issuance of new shares of our common stock, either

through our direct stock purchase and dividend reinvestment plan or through public or private offerings. We may also raise capital by issuing other types of securities, such as preferred stock, convertible debt, or other types of debt securities. As of January 1, 2014, we had approximately 97 million unissued shares of stock authorized for issuance under our charter (although approximately 21 million of these shares are reserved for issuance under our equity compensation plans, dividend reinvestment and stock purchase plan, and outstanding convertible notes). The number of our unissued shares of stock authorized for issuance establishes a limit on the amount of capital we can raise through issuances of shares of stock unless we seek and receive approval from our shareholders to increase the authorized number of our shares in our charter. Also, certain stock change of ownership tests may limit our ability to raise significant amounts of equity capital or could limit our future use of tax losses to offset income tax obligations if we raise significant amounts of equity capital.

In addition, we may not be able to raise capital at times when we need capital or see opportunities to invest capital. Many of the same factors that could make the pricing for investments in real estate loans and securities attractive, such as the availability of assets from distressed owners who need to liquidate them at reduced prices, and uncertainty about credit risk, housing, and the economy, may limit investors' and lenders' willingness to provide us with additional capital. There may be other reasons we are not able to raise capital and, as a result, may not be able to finance growth in our business and in our portfolio of assets. If we are unable to raise

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capital and expand our business and our portfolio of investments, our growth may be limited, we may have to forgo attractive business and investment opportunities, and our operating expenses may increase significantly relative to our capital base.

To the extent we have capital that is available for investment, we have broad discretion over how to invest that capital and our shareholders and other investors will be relying on the judgment of our management regarding its use. To the extent we invest capital in our business or in portfolio assets, we may not be successful in achieving favorable returns.

Conducting our business in a manner so that we are exempt from registration under, and in compliance with, the Investment Company Act may reduce our flexibility and could limit our ability to pursue certain opportunities. At the same time, failure to continue to qualify for exemption from the Investment Company Act could adversely affect us.

Under the Investment Company Act, an investment company is required to register with the SEC and is subject to extensive restrictive and potentially adverse regulations relating to, among other things, operating methods, management, capital structure, dividends, and transactions with affiliates. However, for example, companies primarily engaged in the business of acquiring mortgages and other liens on and interests in real estate are generally exempt from the requirements of the Investment Company Act. We believe that we have conducted our business so that we are not subject to the registration requirements of the Investment Company Act. In order to continue to do so, however, Redwood and each of our subsidiaries must either operate so as to fall outside the definition of an investment company under the Investment Company Act or satisfy its own exclusion under the under the Investment Company Act. For example, certain of our entities limit their ownership or holdings of investment securities to less than 40% of their total assets. Other entities, among other things, must maintain at least 55% of their assets in certain qualifying real estate assets (the 55% Requirement) and are also required to maintain an additional 25% of their assets in such qualifying real estate assets or certain other types of real estate-related assets (the 25% Requirement). Rapid changes in the values of assets we own, however, can disrupt prior efforts to conduct our business to meet these requirements.

If Redwood or one of our subsidiaries fell within the definition of an investment company under the Investment Company Act and failed to qualify for an exclusion or exemption, including, for example, if it failed to meet the 55% Requirement or the 25% Requirement, we could, among other things, be required either (i) to change the manner in which we conduct our operations to avoid being required to register as an investment company or (ii) to register as an investment company, either of which could adversely affect us by, among other things, requiring us to dispose of certain assets or to change the structure of our business in ways that we may not believe to be in our best interests. Legislative or regulatory changes relating to the Investment Company Act or which affect our efforts to qualify for exclusions or exemptions, including our ability to comply with the 55% Requirement and the 25% Requirement, could also result in these adverse effects on us.

If we were deemed an unregistered investment company, we could be subject to monetary penalties and injunctive relief and we could be unable to enforce contracts with third parties and third parties could seek to obtain rescission of transactions undertaken during the period we were deemed an unregistered investment company, unless the court found that under the circumstances, enforcement (or denial of rescission) would produce a more equitable result than no enforcement (or grant of rescission) and would not be inconsistent with the Investment Company Act.

An SEC review, initiated in 2011, of one section of the Investment Company Act and the regulations and regulatory interpretations promulgated thereunder that we rely on to exempt us from registration and regulation as an

investment company under the Investment Company Act could eventually result in legislative or regulatory changes, which could require us to change our business and operations in order for us to continue to rely on that exemption or operate without the benefit of that exemption.

In August 2011, the SEC published a Concept Release within which it reviewed interpretive issues under the Investment Company Act relating to the status under the Investment Company Act of companies that are engaged in the business of acquiring mortgages and mortgage-related instruments and that rely on the exemption set forth in Section 3(c)(5)(C) of the Investment Company Act from requirements under the Investment Company Act. Among other things, the SEC is concerned that certain types of mortgage-related pools today appear to resemble in many respects investment companies such as closed-end funds and may not be the kinds of companies that were intended to be excluded from regulation under the Investment Company Act by Section 3(c)(5)(C). To the extent we rely on Section 3(c)(5)(C) of the Investment Company Act to exempt us from regulation under the Investment Company Act, we believe that our reliance is proper. However, this SEC review could eventually lead to legislative or regulatory changes that could affect our ability to rely on that exemption or could eventually require us to change our business and operations in order for us to continue to rely on that exemption. Even if the SEC's review of this exemption does not eventually have these effects on us, in the interim, while the SEC is carrying out its review, any uncertainty created by the SEC's review process could negatively impact the ability of companies, such as us, that rely on this exemption to raise capital, borrow money, or engage in certain other types of business transactions, which could negatively impact our business and financial results.

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Provisions in our charter and bylaws and provisions of Maryland law may limit a change in control or deter a takeover that might otherwise result in a premium price being paid to our shareholders for their shares in Redwood.

In order to maintain our status as a REIT, not more than 50% in value of our outstanding capital stock may be owned, actually or constructively, by five or fewer individuals (defined in the Internal Revenue Code to include certain entities). In order to protect us against the risk of losing our status as a REIT due to concentration of ownership among our shareholders and for other reasons, our charter generally prohibits any single shareholder, or any group of affiliated shareholders, from beneficially owning more than 9.8% of the outstanding shares of any class of our stock, unless our Board of Directors waives or modifies this ownership limit. This limitation may have the effect of precluding an acquisition of control of us by a third party without the consent of our Board of Directors. Our Board of Directors has granted a limited number of waivers to institutional investors to own shares in excess of this 9.8% limit, which waivers are subject to certain terms and conditions. Our Board of Directors may amend these existing waivers to permit additional share ownership or may grant waivers to additional shareholders at any time.

Certain other provisions contained in our charter and bylaws and in the Maryland General Corporation Law (MGCL) may have the effect of discouraging a third party from making an acquisition proposal for us and may therefore inhibit a change in control. For example, our charter includes provisions granting our Board of Directors the authority to issue preferred stock from time to time and to establish the terms, preferences, and rights of the preferred stock without the approval of our shareholders. Provisions in our charter and the MGCL also restrict our shareholders' ability to remove directors and fill vacancies on our Board of Directors and restrict unsolicited share acquisitions. These provisions and others may deter offers to acquire our stock or large blocks of our stock upon terms attractive to our shareholders, thereby limiting the opportunity for shareholders to receive a premium for their shares over then-prevailing market prices.

The ability to take action against our directors and officers is limited by our charter and bylaws and provisions of Maryland law and we may (or, in some cases, are obligated to) indemnify our current and former directors and officers against certain losses relating to their service to us.

Our charter limits the liability of our directors and officers to us and to shareholders for pecuniary damages to the fullest extent permitted by Maryland law. In addition, our charter authorizes our Board of Directors to indemnify our officers and directors (and those of our subsidiaries or affiliates) for losses relating to their service to us to the full extent required or permitted by Maryland law. Our bylaws require us to indemnify our officers and directors (and those of our subsidiaries and affiliates) to the maximum extent permitted by Maryland law in the defense of any proceeding to which he or she is made, or threatened to be made, a party because of his or her service to us. In addition, we have entered into, and may in the future enter into, indemnification agreements with our directors and certain of our officers and the directors and certain of the officers of certain of our subsidiaries and affiliates which obligate us to indemnify them against certain losses relating to their service to us and the related costs of defense.

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

An investment in our common stock may involve a high degree of risk, particularly when compared to other types of investments. Risks related to the economy, the financial markets, our industry, our investing activity, our other business activities, our financial results, the amount of dividends we distribute, the manner in which we conduct our business, and the way we have structured and limited our operations could result in a reduction in, or the elimination

of, the value of our common stock. The level of risk associated with an investment in our common stock may not be suitable for the risk tolerance of many investors. Investors may experience volatile returns and material losses. In addition, the trading volume of our common stock (i.e., its liquidity) may be insufficient to allow investors to sell their common stock when they want to or at a price they consider reasonable.

Our earnings, cash flows, book value, and dividends can be volatile and difficult to predict. Investors in our common stock should not rely on our estimates, projections, or predictions, or on management's beliefs about future events. In particular, the sustainability of our earnings and our cash flows will depend on numerous factors, including our level of business and investment activity, our access to debt and equity financing, the returns we earn, the amount and timing of credit losses, prepayments, the expense of running our business, and other factors, including the risk factors described herein. As a consequence, although we seek to pay a regular common stock dividend that is sustainable, we may reduce our regular dividend rate, or stop paying dividends, in the future for a variety of reasons. We may not provide public warnings of dividend reductions prior to their occurrence. Although we have paid special dividends in the past, we have not paid a special dividend since 2007 and we may not do so in the future. Changes to the amount of dividends we distribute may result in a reduction in the value of our common stock.

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A limited number of institutional shareholders own a significant percentage of our common stock, which could have adverse consequences to other holders of our common stock.

As of December 31, 2013, based on filings of Schedules 13D and 13G with the SEC, we believe that six institutional shareholders each owned approximately 5% or more of our outstanding common stock and we believe based on data obtained from other public sources that, overall, 225 institutional shareholders owned, in the aggregate, approximately 96% of our outstanding common stock. Furthermore, one or more of these investors or other investors could significantly increase their ownership of our common stock, including through the conversion of outstanding convertible notes into shares of common stock. Significant ownership stakes held by these individual institutions or other investors could have adverse consequences for other shareholders because each of these shareholders will have a significant influence over the outcome of matters submitted to a vote of our shareholders, including the election of our directors and transactions involving a change in control. In addition, should any of these significant shareholders determine to liquidate all or a significant portion of their holdings of our common stock, it could have an adverse effect on the market price of our common stock.

Although, under our charter, shareholders are generally precluded from beneficially owning more than 9.8% of our outstanding common stock, our Board of Directors may amend existing ownership-limitation waivers or grant waivers to other shareholders in the future, in each case in a manner which may allow for increases in the concentration of the ownership of our common stock held by one or more shareholders.

Future sales of our common stock by us or by our officers and directors may have adverse consequences for investors.

We may issue additional shares of common stock, or securities convertible into shares of common stock, in public offerings or private placements, and holders of our outstanding convertible notes may convert those securities into shares of common stock. In addition, we may issue additional shares of common stock to participants in our direct stock purchase and dividend reinvestment plan and to our directors, officers, and employees under our employee stock purchase plan, our incentive plan, or other similar plans, including upon the exercise of, or in respect of, distributions on equity awards previously granted thereunder. We are not required to offer any such shares to existing shareholders on a preemptive basis. Therefore, it may not be possible for existing shareholders to participate in future share issuances, which may dilute existing shareholders' interests in us. In addition, if market participants buy shares of common stock, or securities convertible into shares of common stock, in issuances by us in the future, it may reduce or eliminate any purchases of our common stock they might otherwise make in the open market, which in turn could have the effect of reducing the volume of shares of our common stock traded in the marketplace, which could have the effect of reducing the market price and liquidity of our common stock.

At February 24, 2014, our directors and executive officers beneficially owned, in the aggregate, approximately 2.6% of our common stock. Sales of shares of our common stock by these individuals are generally required to be publicly reported and are tracked by many market participants as a factor in making their own investment decisions. As a result, future sales by these individuals could negatively affect the market price of our common stock.

There is a risk that you may not receive dividend distributions or that dividend distributions may decrease over time. Changes in the amount of dividend distributions we pay, in the tax characterization of dividend distributions we pay, or in the rate at which holders of our common stock are taxed on dividend distributions we pay, may adversely affect the market price of our common stock or may result in holders of our common stock being taxed on dividend distributions at a higher rate than initially expected.

Our dividend distributions are driven by a variety of factors, including our minimum dividend distribution requirements under the REIT tax laws and our REIT taxable income as calculated for tax purposes pursuant to the Internal Revenue Code. We generally intend to distribute to our shareholders at least 90% of our REIT taxable income, although our reported financial results for GAAP purposes may differ materially from our REIT taxable income.

For 2013, we maintained our regular dividend at a rate of \$0.28 per share per quarter and in November 2013 our Board of Directors announced its intention to continue to pay regular dividends during 2014 at a rate of \$0.28 per share per quarter. Our ability to pay a dividend of \$0.28 per share per quarter in 2014 may be adversely affected by a number of factors, including the risk factors described herein. These same factors may affect our ability to pay other future dividends. In addition, to the extent we determine that future dividends would represent a return of capital to investors, rather than the distribution of income, we may determine to discontinue dividend payments until such time that dividends would again represent a distribution of income. Any reduction or elimination of our payment of dividend distributions would not only reduce the amount of dividends you would receive as a holder of our common stock, but could also have the effect of reducing the market price of our common stock.

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The rate at which holders of our common stock are taxed on dividends we pay and the characterization of our dividends as ordinary income, capital gains, or a return of capital could have an impact on the market price of our common stock. In addition, after we announce the expected characterization of dividend distributions we have paid, the actual characterization (and, therefore, the rate at which holders of our common stock are taxed on the dividend distributions they have received) could vary from our expectation, including due to errors, changes made in the course of preparing our corporate tax returns, or changes made in response to an IRS audit), with the result that holders of our common stock could incur greater income tax liabilities than expected.

The market price of our common stock could be negatively affected by various factors, including broad market fluctuations.

The market price of our common stock may be negatively affected by various factors, which change from time to time. Some of these factors are:

Our actual or anticipated financial condition, performance, and prospects and those of our competitors.

The market for similar securities issued by other REITs and other competitors of ours.

Changes in the manner that investors and securities analysts who provide research to the marketplace on us analyze the value of our common stock (for example, if, at a time when the market price of our common stock is significantly above book value per share, investors and analysts change their method of analyzing the value of our common stock and take the position that our common stock should not be valued at a significant premium to book value per share, which could occur if investors and analysts do not believe there is reason to have a positive outlook on the prospects for our business and financial results).

Changes in recommendations or in estimated financial results published by securities analysts who provide research to the marketplace on us, our competitors, or our industry.

General economic and financial market conditions, including, among other things, actual and projected interest rates, prepayments, and credit performance and the markets for the types of assets we hold or invest in.

Proposals to significantly change the manner in which financial markets, financial institutions, and related industries, or financial products are regulated under applicable law, or the enactment of such proposals into law or regulation.

Other events or circumstances which undermine confidence in the financial markets or otherwise have a broad impact on financial markets, such as the sudden instability or collapse of large financial institutions or

other significant corporations (whether due to fraud or other factors), terrorist attacks, natural or man-made disasters, or threatened or actual armed conflicts.

Furthermore, these fluctuations do not always relate directly to the financial performance of the companies whose stock prices may be affected. As a result of these and other factors, investors who own our common stock could experience a decrease in the value of their investment, including decreases unrelated to our financial results or prospects.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Redwood Trust has one lease for its principal executive and administrative offices located at One Belvedere Place, Mill Valley, California 94941, which expires in 2018. The 2014 rent obligation for this lease in Mill Valley is \$1.5 million. Redwood has one lease for offices at 8310 South Valley Highway, Englewood, CO 80112, which expires in 2021. The 2014 rent obligation for this lease in Colorado is \$0.4 million. Redwood has one lease for administrative offices at 1114 Avenue of the Americas 3rd Floor, New York, NY 10036, which expires in 2015. The 2014 rent obligation for this lease in New York is \$0.3 million. Redwood has one lease for administrative offices at 4000 MacArthur Blvd, Suite 600, Newport Beach, California 92660. This is a six-month lease that automatically renews at the end of each period. The 2014 rent obligation for this lease in Newport Beach is \$21 thousand.

ITEM 3. 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

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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 December 31, 2013, the FHLB-Seattle has received approximately \$114.4 million of principal and \$11.0 million of interest payments in respect of the Seattle Certificate. As of December 31, 2013, the Seattle Certificate had a remaining outstanding principal amount of approximately \$19.0 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 December 31, 2013, Schwab has received approximately \$12.7 million of principal and \$1.3 million of interest payments in respect of the Schwab Certificate. As of December 31, 2013, the Schwab Certificate had a remaining outstanding principal amount of approximately \$2.1 million. SRF has denied Schwab's allegations. We intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters are also named 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 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 December 31, 2013, the FHLB Chicago has received approximately \$72.3 million of principal and \$24.2 million of interest payments in respect of this Chicago Certificate. As of December 31, 2013, this Chicago Certificate had a remaining outstanding principal amount of approximately \$32.0 million (after taking into account approximately \$1.0 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 December 31, 2013, the FHLB Chicago has received approximately \$258.6 million of principal and \$81.5 million of

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interest payments in respect of this Chicago Certificate. As of December 31, 2013, this Chicago Certificate had a remaining outstanding principal amount of approximately \$113.7 million (after taking into account approximately \$6.3 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 early stages of discovery, and no trial date has been set. We intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2006-1 RMBS, which underwriters are also named 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 3 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 4. Mine Safety Disclosures

Not applicable.

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Our common stock is listed and traded on the NYSE under the symbol RWT. At February 24, 2014, our common stock was held by approximately 950 holders of record and the total number of beneficial stockholders holding stock through depository companies was approximately 29,000 at February 25, 2014. At February 24, 2014, there were 82,534,625 shares of common stock outstanding.

The high and low sales prices of shares of our common stock, as reported by the Bloomberg Financial Markets service, and the cash dividends declared on our common stock for each full quarterly period during 2013 and 2012 were as follows:

	Stock Prices		Common Dividends Declared			
	High	Low	Record Date	Payable Date	Per Share	Dividend Type
<u>Year Ended December 31, 2013</u>						
Fourth Quarter	\$ 19.77	\$ 17.10	12/13/2013	12/27/2013	\$ 0.28	Regular
Third Quarter	\$ 20.07	\$ 16.32	9/13/2013	9/30/2013	\$ 0.28	Regular
Second Quarter	\$ 23.32	\$ 16.44	6/14/2013	6/28/2013	\$ 0.28	Regular
First Quarter	\$ 23.59	\$ 17.51	3/15/2013	3/29/2013	\$ 0.28	Regular
<u>Year Ended December 31, 2012</u>						
Fourth Quarter	\$ 17.00	\$ 13.95	12/14/2012	12/27/2012	\$ 0.25	Regular
Third Quarter	\$ 15.04	\$ 12.38	9/14/2012	9/28/2012	\$ 0.25	Regular
Second Quarter	\$ 12.61	\$ 11.08	6/15/2012	6/29/2012	\$ 0.25	Regular
First Quarter	\$ 12.23	\$ 10.15	3/15/2012	3/30/2012	\$ 0.25	Regular

All dividend distributions are made with the authorization of the board of directors at its discretion and will depend on such items as our GAAP net income, REIT taxable earnings, financial condition, maintenance of REIT status, and other factors that the board of directors may deem relevant from time to time. The holders of our common stock share proportionally on a per share basis in all declared dividends on common stock. As reported on our Current Report on Form 8-K on January 28, 2014, for dividend distributions made in 2013, we expect 89% of our dividends paid in 2013 to be characterized as ordinary income and 11% to be characterized as a return of capital for income tax purposes. None of the dividend distributions made in 2013 is expected to be characterized for federal income tax purposes as long-term capital gain dividends.

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 year ended December 31, 2013. At December 31, 2013, 4,005,985 shares remained available for repurchase under our stock repurchase plan.

Information with respect to compensation plans under which equity securities of the registrant are authorized for issuance is set forth in Part II, Item 12 of this Annual Report on Form 10-K.

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The following graph presents a cumulative total return comparison of our common stock, over the last five years, to the S&P Composite-500 Stock Index and the National Association of Real Estate Investment Trusts, Inc. (NAREIT) Mortgage REIT index. The total returns reflect stock price appreciation and the reinvestment of dividends for our common stock and for each of the comparative indices, assuming that \$100 was invested in each on December 31, 2008. The information has been obtained from sources believed to be reliable; but neither its accuracy nor its completeness is guaranteed. The total return performance shown on the graph is not necessarily indicative of future performance of our common stock.

	2008	2009	2010	2011	2012	2013
Redwood Trust, Inc	100.00	103.47	114.20	84.13	150.51	182.77
NAREIT Mortgage REIT Index	100.00	124.52	152.68	148.90	179.08	176.11
S&P Composite-500 Index	100.00	126.45	145.49	148.55	172.31	228.10

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The following selected financial data is qualified in its entirety by, and should be read in conjunction with, the more detailed information contained in the Consolidated Financial Statements and Notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report on Form 10-K and in our Annual Reports on Form 10-K as of and for each of the years ended December 31, 2013, 2012, 2011, 2010, and 2009. Certain amounts for prior periods have been reclassified to conform to the 2013 presentation.

(thousands, Except Per Share Data)	2013	2012	2011	2010	2009
Consolidated Statement of Operations Data:					
Net income	\$ 226,156	\$ 231,384	\$ 217,179	\$ 230,054	\$ 287,877
Net expense	(80,971)	(120,705)	(98,978)	(84,664)	(132,000)
Interest income	145,185	110,679	118,201	145,390	155,877
Provision for loan losses	(4,737)	(3,648)	(16,151)	(24,135)	(49,573)
Interest income after provision	140,448	107,031	102,050	121,255	106,304
Interest income					
mortgage banking activities, net	100,676	36,319	-	-	-
mortgage servicing rights income, net	20,309	(1,391)	-	-	-
mortgage market valuation adjustments, net	(5,709)	1,539	(40,017)	(19,554)	(87,622)
Other mortgage gains, net	25,259	54,921	10,946	63,496	63,160
Noninterest income	140,535	91,388	(29,071)	43,942	(24,462)
Operating expenses	(84,789)	(65,359)	(47,741)	(53,715)	(46,993)
Provision for expense	(12,000)	-	-	-	-
Provision for) benefit from income taxes	(10,948)	(1,291)	(42)	(280)	4,260
Income	173,246	131,769	25,196	111,202	39,111
Net (loss) income attributable to controlling interest	-	-	(1,147)	1,150	(8,000)
Income Attributable to Redwood Trust, Inc.	\$ 173,246	\$ 131,769	\$ 26,343	\$ 110,052	\$ 39,191
Weighted average common shares basic	81,985,897	79,529,950	78,299,510	77,841,634	68,458,000
Earnings per share basic	\$ 2.05	\$ 1.61	\$ 0.31	\$ 1.37	\$ 0.55
Weighted average common shares diluted	93,694,924	80,673,682	78,299,510	78,810,949	68,990,890
Earnings per share diluted	\$ 1.94	\$ 1.59	\$ 0.31	\$ 1.36	\$ 0.55
Annual dividends declared per common share	\$ 1.12	\$ 1.00	\$ 1.00	\$ 1.00	\$ 1.00

Consolidated Balance Sheet Data:

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ing assets		\$ 4,519,775	\$ 4,343,628	\$ 5,613,753	\$ 5,049,254	\$ 5,090,18
assets		\$ 4,608,528	\$ 4,444,098	\$ 5,743,298	\$ 5,143,688	\$ 5,252,65
-term debt		\$ 862,763	\$ 551,918	\$ 428,056	\$ 44,137	\$ -
t-backed securities issued						
uritization		\$ 94,934	\$ 164,746	\$ 219,551	\$ -	\$ -
t-backed securities issued						
mercial		\$ 153,693	\$ 171,714	\$ -	\$ -	\$ -
t-backed securities issued	Sequoia	\$ 1,694,335	\$ 2,193,481	\$ 3,710,423	\$ 3,458,501	\$ 3,644,93
t-backed securities issued	Acacia	\$ -	\$ -	\$ 209,381	\$ 303,077	\$ 297,59
-term debt		\$ 476,467	\$ 139,500	\$ 139,500	\$ 139,500	\$ 140,00
liabilities		\$ 3,362,745	\$ 3,303,934	\$ 4,850,714	\$ 4,068,096	\$ 4,263,55
ontrolling interest		\$ -	\$ -	\$ -	\$ 10,839	\$ 17,37
stockholders equity		\$ 1,245,783	\$ 1,140,164	\$ 892,584	\$ 1,064,753	\$ 971,72
ber of common shares outstanding		82,504,801	81,716,416	78,555,908	78,124,668	77,737,13
value per common share		\$ 15.10	\$ 13.95	\$ 11.36	\$ 13.63	\$ 12.5

Selected Data:

age assets		\$ 4,681,989	\$ 5,318,442	\$ 5,357,065	\$ 5,196,293	\$ 5,329,46
age debt and ABS issued outstanding		\$ 3,333,439	\$ 4,130,216	\$ 4,148,421	\$ 4,011,855	\$ 4,461,74
age stockholders equity		\$ 1,200,461	\$ 987,330	\$ 1,003,523	\$ 1,008,126	\$ 729,03
income/average stockholders equity		14.4 %	13.3 %	2.6 %	10.9 %	5.

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ITEM 7. 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 8, Financial Statements and Supplementary Data of this 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 in Part 1, Item 1, Business and in Part 1, Item 1A, Risk Factors of this Annual Report on Form 10-K.

OVERVIEW

Our Business

Redwood Trust, Inc., together with its subsidiaries, is an internally-managed specialty finance company focused on engaging in residential and commercial mortgage banking activities and investing in mortgage- and other real estate-related assets. 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 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 income from our mortgage banking activities. Net interest income consists of the interest income we earn less the interest expenses 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).

For additional detail on our business, refer to Part I, Item 1, Business of this Annual Report on Form 10-K.

Our Strategy

Following the financial crisis that began in 2007, we made a strategic decision to invest in and build out our residential and commercial loan platforms. We did this with the goal of creating our own steady sources of attractive investments and income-generating opportunities. Overall, there is commonality between our residential and commercial platforms. In both cases, we have established ourselves as an intermediary between borrowers and institutions that invest in residential mortgages and commercial real estate loans through the capital markets. We believe this strategy is well suited to the structure of our balance sheet and the talents and extensive relationships of the professionals who make up our residential and commercial teams.

Since mid-2010, our residential strategy has been focused on acquiring prime, jumbo mortgages for sale through private-label securitization or to institutions that acquire pools of whole loans. While the initial market opportunity appeared small, this strategy has been driven by three primary business assumptions: 1) the government would eventually reduce its outsized role in the mortgage market; 2) new bank regulation (including the implementation of the Basel III capital accord) and legacy portfolio issues at banks

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would open up an opportunity for independent mortgage companies; and 3) institutional investors that have traditionally invested in triple-A rated mortgage-backed securities would, over time, return to the market to provide attractive financing for prime residential loans through their acquisitions of newly-issued securities. We believe these business assumptions are playing out, although Federal Reserve monetary policy, the pace and direction of mortgage industry legislative and regulatory reform, competitive factors, and market conditions will affect the extent to which they will positively impact our jumbo mortgage business over the near-term. To complement our jumbo mortgage business, beginning in late 2013 we expanded our residential loan platform to include acquiring conforming mortgage loans, which are loans eligible for sale to Fannie Mae and Freddie Mac.

Since 2010, our commercial strategy has been focused on responding to commercial loan refinancing demand brought about by the pre-crisis era of high-leverage lending. An immediate opportunity was identified for mezzanine lending that could bridge the gap between commercial borrowers' funding needs and the level of financing traditional senior lenders would provide. Beginning in 2012, we also positioned our platform to originate senior commercial loans, with these senior loans being sold primarily to third parties for securitization.

Business Update

We had a productive year at Redwood in 2013 and finished in a strong position. Our book value per share, earnings per share, and dividends all increased on a year-over-year basis, contributing to a 21.4% total return for shareholders for 2013. The Financial and Operational Overview that follows this section provides a summary of our financial results in 2013. From an operational perspective, we continued to build our residential and commercial businesses throughout 2013. This included executing on our strategy to invest in mortgage servicing rights, established a new residential mortgage processing center in Denver, and entering the conforming mortgage sector in the fourth quarter of 2013. Our vision and business strategy for Redwood are driven by the market opportunities we see over the next several years, not over the next several quarters. That long-term perspective gives us confidence that both our residential and commercial businesses, while still in the early stages of expansion, are well positioned for opportunistic growth as these markets evolve.

Over the past four years, we have built residential and commercial loan acquisition platforms with the primary objective being to create a proprietary source of attractive investments and income-generating opportunities. Sourcing investments solely through a bid-in-competition process has become less productive for us in this liquidity-flooded world, as available risk-adjusted investment yields continue to move lower. Our loan acquisition platforms provide us with strong competitive advantages, including the ability to leverage our seller relationships, infrastructure, and distribution capabilities. The competitive barriers to building an effective platform for creating investments are high and there is no fast or easy way to replicate the platforms we have been building over the past four years. Our efforts have required significant effort, capital, and expense. Looking back on the progress we have made, we believe the investments have been well worth it.

We believe 2014 has the potential to be another good year for our commercial business, while the near-term outlook for our residential business is likely to be more challenging for us as well as all other residential market participants. These challenges have our full attention and we believe that our focus on the long-term direction of the residential and commercial mortgage markets, coupled with the strategic actions we are taking, positions Redwood to be a leading investor and provider of private risk capital to the mortgage market over the long term.

The following sections discuss our view of the longer-term direction of the residential and commercial mortgage markets, the market opportunity for Redwood, and how we believe we are positioned to grow and succeed.

Residential

In relation to residential investments and mortgage banking activities, our foremost objectives are to invest in well-underwritten, prime mortgage credit risk and associated servicing rights, and to generate income from loan sales. Until recently, we have been focused primarily on the jumbo segment of the market. Having recently obtained approval as a Fannie Mae and Freddie Mac seller/servicer, however, we now have the ability to acquire conforming loans for sale to these government-sponsored enterprises (GSEs), thus significantly expanding our market opportunities.

We believe that the outlook for investing in newly originated prime mortgage credit risk looks promising. While we continue to create and retain credit securities through our Sequoia securitization program, our entry into the much larger conforming market positions us to pursue credit investments in conforming loans through potential credit risk-sharing arrangements with the GSEs.

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The private label market for residential securitization clearly experienced turmoil during 2013, as yields demanded by investors in triple-A rated RMBS increased from early in the second quarter through the end of the year. However, we believe that over the long term, private-label residential mortgage securitization will return to being an efficient form of mortgage financing and will play a substantial role in the mortgage market, alongside government-supported financing, and bank portfolio lending. We believe triple-A investors will return to the private label securitization market for prime quality loans when improved securitization structures and issuer best practices become widely adopted by participants, thus restoring confidence among investors. Ultimately, we believe that investing in securitized products is one of the most efficient ways for institutional investors to make residential mortgage investments. We also expect that the credit support levels required by rating agencies for RMBS transactions will decline over time, reflecting the performance of the underlying collateral, and this will improve the profitability of securitization transactions for issuers such as Redwood.

Currently, we have been seeing market fundamentals begin to stabilize, while the pricing for triple-A rated RMBS is beginning to show signs of improvement for issuers like us. However, based on the significant volatility in triple-A rated RMBS pricing over the past two years, it is difficult to project the near-term direction of the market with confidence. Redwood completed one private-label residential securitization during the fourth quarter of 2013, and we expect to complete another late in the first quarter or early in the second quarter of 2014. While we continue to prefer to securitize jumbo loans we acquire (because of our ability to create attractive investments for our portfolio), given the current state of the securitization market, we expect whole-loan sales to continue in the near term to account for the disposition of the majority of the jumbo loans we accumulate. Between these two primary distribution outlets (securitization and whole loan sales), we still believe that we can generate attractive loan sale profit margins within our long-term target range of 25 to 50 basis points. (Our loan sale margins exceeded this target range in 2013.)

In 2013, we acquired \$6.9 billion of jumbo mortgage loans, a large increase from 2012 when we acquired \$2.3 billion, but short of our upwardly revised goal of \$8 billion we set for ourselves in mid-2013. In 2014, we expect to increase the number of sellers we acquire loans from. While we expect that our jumbo acquisition volume in 2014 will be lower than in 2013, we expect this decline to be less than the 32% decline projected for the industry as a whole. With respect to conforming residential loans, our goal is to ramp up to a run rate of acquiring \$1 billion per month by the end of 2014. We do not expect that ramp up to occur smoothly over the course of 2014, however, given our internal processes for expanding product offerings to our sellers as well as the declining projections we have observed in industry-wide origination as a result of interest-rate volatility.

With respect to government policy issues, we believe the long process of GSE reform will eventually conclude with the creation of an entity or multiple entities that function much as the GSEs do today. We believe the new entities will continue to support some type of conforming mortgage financing to mainstream U.S. borrowers, with the private sector absorbing first-loss credit risk, ahead of a government guarantee. This would represent a very large potential market opportunity for private credit risk investors, especially those with loan acquisition platforms such as Redwood. The foundation for this new structure is already being laid while the GSEs are in conservatorship through structured and contractual credit risk-sharing arrangements with the GSEs.

Commercial

Our commercial team had a successful year in 2013, originating \$805 million of senior commercial loans. Although we fell short of our goal of \$1 billion of senior commercial originations, our loan sale profit margins exceeded our expectations, as did the overall profitability of this business.

In the near term, if the economy continues to move forward with low-to-moderate growth in 2014, underlying commercial real estate fundamentals should continue to moderately improve as well. Various industry forecasts call for CMBS issuance to increase in 2014 for the fifth consecutive year to a range of \$90 to \$100 billion, compared to approximately \$85 billion in 2013. With close to \$250 billion of commercial real estate loans set to mature annually over the next four years, we expect to see substantial refinancing opportunities for those with established commercial origination platforms such as Redwood.

We plan to expand our commercial platform in 2014 by adding experienced originators, positioning us to exceed the \$1 billion annual commercial senior loan origination goal, while also boosting our mezzanine loan origination activity. We currently project that the capital we had previously allocated to our commercial mortgage banking and investment activities should remain adequate for us to continue growing this platform.

Table of Contents**Index to Financial Statements****2013 Financial and Operational Overview**

Redwood generated strong earnings growth in 2013. Net income increased 31% to \$173 million, and earnings per share increased 22% to \$1.94 per share in 2013, resulting in a 14.43% return on equity. The following table presents selected financial highlights from 2013 and 2012.

Table 1 Selected Financial Highlights

(In Dollars, per share basis)	December 31,	
	2013	2012
Net Income per diluted share	\$ 1.94	\$ 1.59
REIT Taxable Income per share	0.93	0.75
Return on Equity	14.43%	13.35%
Book Value per share	15.10	13.95
Dividends per share	1.12	1.00

The increase in net income in 2013 was primarily driven by significant growth in our residential and commercial mortgage banking operations along with continued positive performance from our residential investments portfolio. Higher net income also contributed to an increase in our book value to \$15.10 per share and also supported increased dividends of \$1.12 per share paid in 2013. The following table presents the changes in book value per share for the year ended December 31, 2013.

Table 2 Changes in Book Value per Share

(In Dollars, per share basis)	Year Ended December 31, 2013
Beginning book value per share	\$ 13.95
Net income	1.94
Changes in unrealized gains/losses, net	(0.27)
Unrealized gains on hedges, net	0.39
Equity issuance	0.11
Other, net	0.10
Dividends	(1.12)
Ending Book Value per Share	\$ 15.10

We deployed \$583 million of capital into new investments in 2013, as summarized in the following table.

Table 3 Investment Activity

(In Millions) ⁽¹⁾	Year Ended December 31, 2013
Residential investments	
Sequoia RMBS	\$ 392
Third-Party RMBS	489
Less: Short-term debt	(397)
MSR Investments	48
Net residential investments	532
Commercial mezzanine investments	66
Less: Borrowings	(15)
Net commercial investments	50
Equity Capital Invested	\$ 583

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

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Residential Mortgage Banking

Our residential mortgage banking business was very active during 2013, with loan acquisitions rising to \$7.1 billion from \$2.3 billion in 2012, accompanied by the completion of 12 residential prime jumbo securitizations for a total of \$5.58 billion during the year, as compared to six securitizations for \$1.97 billion during 2012. Due to the Federal Reserve's accommodative policy actions, interest rates were at historical lows during most of the first half of 2013, spurring significant refinancing volumes. During this time we continued to increase the number of sellers we purchase loans from and saw our acquisition volumes rise significantly.

Beginning late in the second quarter, long-term interest rates began to rise as the bond market began responding to the Federal Reserve's long anticipated plan to begin tapering its purchases of Treasury and mortgage-backed securities (MBS). Benchmark interest rates were volatile during the following months, but overall increased through the end of the year, with the benchmark 10-Year Treasury yield rising 88 basis points to 3.04%, from 2.16% at the end of May. According to Freddie Mac's Primary Mortgage Market Survey, over the same period the average weekly rate for a 30-year fixed-rate conforming mortgage increased 72 basis points to 4.53% by the end of the year, which was 119 basis points higher than a year ago. As a result of the increase in interest rates, the Mortgage Bankers Association reported in late December that its mortgage application index had declined to a 13-year low as refinance related application activity fell to its lowest level since November 2008.

Beginning in the third quarter of 2013, large banks began to offer rates for higher-quality 30-year jumbo loans through their retail loan channels below the rates they were offering for conforming loans. This highly competitive jumbo mortgage pricing is reflective of a combination of the increased guarantee fees that Fannie Mae and Freddie Mac required for conforming loans, and the desire of the larger banks with excess liquidity to invest in higher yielding and presumably safer jumbo mortgages. However, the larger banks have not been as aggressive in pricing jumbo loans through their correspondent lending channels and we are currently able to offer competitive rates and we continue to acquire loans.

As a result of these recent market conditions, including rising interest rates, declining refinance-related loan origination activity, and the aggressive pricing of jumbo mortgage loans by large banks, over the course of the third and fourth quarters of 2013, we saw the volume of loans we identified for purchase and our acquisitions decline. Despite the competitive environment, we have continued to acquire loans, at a slower pace, from a growing number of sellers. We continued to add loan sellers to our platform throughout the year, increasing the total number of active sellers to 118 at December 31, 2013, consisting of 55 regional banks (or their subsidiaries) and 63 mortgage companies, located throughout the U.S.

The following chart presents the amount of loans identified for purchase, loans purchased, and our active sellers over the last five quarters.

Rising mortgage rates and competition from large banks also had an impact on the private mortgage securitization market, resulting in reduced activity in the third and fourth quarters of 2013. There were three private-label non-conforming securitizations completed by market participants totaling \$0.8 billion in the fourth quarter, down from nine securitizations totaling \$3.9 billion in the third quarter of 2013, and 19 securitizations totaling \$8.3 billion during the first half of 2013. In summary, the rising interest rate environment has caused triple-A investors to require yields

in excess of what can be structured from the underlying mortgage loans. As a result, we currently expect to complete another Sequoia securitization late in the first quarter or early in the second quarter of 2014. We continue to value our leadership position in private securitization and remain committed to expanding this area of our business as market conditions improve.

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While the private mortgage securitization market slowed in the second half of 2013, we began to see better execution in the whole loan market and sold \$1.25 billion of whole loans through this channel in the second half of 2013 as compared to \$311 million in the first half of 2013. Bank demand for whole jumbo mortgage loans is strong and reflects the excess liquidity in the banking system and, to a lesser extent, favorable accounting treatment of whole loans relative to securities. As such, we expect to remain active in the whole loan market in 2014.

During 2013, we also became an approved seller/servicer to both Fannie Mae and Freddie Mac. This allowed us to begin purchasing conforming loans that meet Fannie Mae's and Freddie Mac's eligibility criteria in the fourth quarter of 2013. This will also enable us to create our own investments in conforming mortgage servicing rights and positions us to be involved in risk-sharing opportunities relating to these types of loans to the extent those opportunities arise in the future, consistent with the concept envisioned by the Federal Housing Finance Agency.

In part to position ourselves to participate in the conforming loan market and also to accommodate increased jumbo loan production, we invested heavily in our infrastructure during 2013, opening our Denver office and adding scalability to our support operations and systems. As such, direct segment operating costs for residential mortgage banking increased, primarily related to increased headcount and systems upgrades.

Residential Investments

We continued to grow our residential investment portfolio in 2013, increasing the portfolio to \$1.64 billion at the end of 2013 from \$1.10 billion at the end of 2012. The increase in 2013 primarily resulted from the acquisition of senior and subordinate securities and to a lesser extent MSR. During the first half of 2013, nearly all of the new securities we acquired in this portfolio were subordinate securities retained from our Sequoia securitizations. These additions were partially offset by continued paydowns as well as strategic sales of senior third-party securities as we looked to reallocate our capital invested in this portfolio.

As discussed in the Residential Mortgage Banking section above, our mortgage loan acquisition volumes decreased significantly in the second half of 2013. This, in combination with a shift toward greater sales through whole loan executions rather than through securitizations, limited the amount of new Sequoia securities and MSR available to add to our portfolio. During the second half of 2013, we began allocating investment capital into select third-party seasoned senior securities and new-issue subordinate securities. In the near term, we expect industry-wide jumbo securitization volume to remain more limited, although market conditions can change quickly. We continue to expect growth in this business segment will likely come from new investments in MSR retained from our residential mortgage banking business in addition to opportunistic investments in third-party securities. In the longer-term, we anticipate our portfolio will transition towards a mix of credit and MSR investments, with a smaller percentage of our capital invested in third-party senior securities.

At the end of 2013, our securities portfolio was comprised of 55% senior securities, 34% subordinate securities (30% new-issue subordinates and 4% legacy third-party subordinates) and 11% re-REMIC securities. This compares to 67% senior securities, 18% subordinate securities and 15% re-REMIC securities at the end of 2012. A portion of our senior securities have been resecured to provide long-term financing and the remainder are financed with a combination of capital and short-term debt.

Most of the senior securities we own are backed by adjustable-rate mortgages (ARMs), or hybrid interest-rate loans that have reset to traditional ARMs, making them less sensitive to changes in interest rates. The subordinate securities we retained from our Sequoia securitizations are predominately backed by fixed-rate collateral making them sensitive

to changes in interest rates in addition to credit performance. During 2013, there were minimal overall net fair value changes in our securities portfolio as the impact from rising interest rates was mostly offset by tightening of credit spreads. Increasing interest rates did impact the value of our MSR portfolio, resulting in \$12 million of positive market valuation adjustments, bringing the total estimated fair value of this portfolio to \$65 million at the end of 2013.

Commercial Mortgage Banking and Investments

The commercial real estate market continued to improve in 2013 along with the overall economy. Strong demand for CMBS throughout the year facilitated the growth of our commercial operations in 2013, as we shifted our focus from the origination of mezzanine loans to be retained for our investment portfolio to senior loans that we sell through to the capital markets associated with our mortgage banking activities. As a result, we originated \$805 million of senior loans in 2013 as compared to \$60 million in 2012. These higher senior loan origination volumes resulted in higher income from commercial mortgage banking activities.

With our shift in focus away from the origination of mezzanine loan investments, our origination of loans for our investment portfolio decreased to \$66 million in 2013 from \$156 million in 2013. Our mezzanine loan originations in 2013 were partially offset by two loan

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pay-offs, bringing the balance of this portfolio to \$343 million at the end of 2013. Our returns from this portfolio remained relatively consistent in 2013 with unlevered yields in excess of 10% per annum before credit costs.

Cash, Debt, and Capital

At December 31, 2013, our cash amounted to \$173 million and our current investment capacity (defined as the approximate amount of capital we have readily available for long-term investments) was estimated to be approximately \$136 million. Our total capital of \$1.67 billion at December 31, 2013 included \$1.25 billion of equity capital and \$427 million of long-term debt.

We ended 2013 with short-term warehouse debt of \$185 million, which was used to finance residential loans, and had additional uncommitted borrowing capacity of \$1.2 billion under existing warehouse lines of credit to finance additional residential and commercial loans. Our short-term debt used to finance securities at December 31, 2013 was \$678 million.

We currently expect that our available capital and liquidity is sufficient to fund our business and investment objectives for most or all of 2014, in part because we believe we can source capital internally by selling or financing existing investments if needed to fund higher yielding investment opportunities. To the extent our expectation changes and we need external capital to fund our investment and business activities, we would consider the issuance of debt or equity securities under the shelf registration statement we currently have on file with the SEC, or the issuance of similar or other types of securities in public or private offerings, including, the possibility of raising dedicated capital for our commercial platform.

RESULTS OF OPERATIONS

The following table presents the components of our GAAP net income for the years ended December 31, 2013, 2012, and 2011.

Table 4 Net Income

(In Millions, Except per Share Data) ⁽¹⁾	Year Ended December 31,		
	2013	2012	2011
Interest income	\$ 226	\$ 231	\$ 217
Interest expense	(81)	(121)	(99)
Net Interest Income	145	110	118
Provision for loan losses	(5)	(4)	(16)
Net Interest Income After Provision	140	106	102
Noninterest Income			
Mortgage banking activities, net	101	36	-
MSR income (loss), net	20	(1)	-

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Other market valuation adjustments, net	(6)	2	(40)
Realized gains, net	25	55	11
Total noninterest income	141	91	(29)
Operating expenses	(85)	(65)	(48)
Other expense	(12)	-	-
Net income before provision for income taxes	184	133	25
Provision for income taxes	(11)	(1)	-
Net income	173	132	25
Less: Net loss attributable to noncontrolling interest	-	-	(1)
Net Income Attributable to Redwood Trust, Inc.	\$ 173	\$ 132	\$26
Diluted earnings per common share	\$ 1.94	\$ 1.59	\$ 0.31

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

We are required under GAAP to consolidate the assets and liabilities of certain securitization entities we have sponsored for financial reporting purposes. However, each of these entities is independent of Redwood and of each other and 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 flows generated by their securitized assets and are not obligations of Redwood. We refer to certain of these securitization entities as Legacy Consolidated Entities, and where

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applicable, in analyzing our results of operations we distinguish results from current operations at Redwood and from Legacy Consolidated Entities. For additional detail on results from Legacy Consolidated Entities, see the *Results From Legacy Consolidated Entities* section below. Results at Redwood include all activities from our three business segments.

Net Interest Income After Provision

In 2013, net interest income after provision increased \$33 million to \$140 million, including \$23 million of increases at Redwood and \$10 million of increases at Legacy Consolidated Entities. The increase at Redwood was primarily attributable to increased interest income resulting from higher average balances of loans held for sale or securitization during 2013 related to both our residential and commercial mortgage banking activities, in addition to higher average balances of Sequoia IO securities in our residential mortgage banking segment and Sequoia subordinate securities in our residential investment portfolio. Net interest income at Redwood in 2013 also reflects an increase in interest expense, with the majority of the increase resulting from our convertible debt issued in the first quarter of 2013 and from our Commercial Securitization that was completed in the fourth quarter of 2012. The increase attributable to Legacy Consolidated Entities was primarily related to interest expense of \$11 million recorded in 2012 related to the deconsolidation of certain legacy entities during the fourth quarter of 2012.

In 2012, net interest income after provision increased \$5 million to \$107 million, including \$14 million of increases at Redwood offset by a \$9 million decrease at Legacy Consolidated Entities. The increase at Redwood was primarily attributable to increased interest income from our commercial investment portfolio, which grew substantially during 2012, as well as from higher average balances of residential securities and residential loans held for sale or securitization. The increase in interest income was partially offset by an increase in interest expense as we funded the addition of certain assets in part with debt. The decline in net interest income after provision at Legacy Consolidated Entities is primarily related to the deconsolidation of certain entities discussed above as well as a significant decline in delinquent loan balances at certain consolidated Sequoia entities during 2012.

Additional detail on changes in net interest income at Redwood is provided in the *Net Interest Income* section below.

Mortgage Banking Activities, Net

Mortgage banking activities, net, include valuation changes of residential and commercial loans, valuation changes related to derivatives and Sequoia IO securities used in part to offset risks associated with our mortgage banking activities, and gains from loan sales and securitizations. In 2013, income from mortgage banking activities increased \$65 million to \$101 million. The majority of this increase was attributable to our residential mortgage banking operations, which contributed \$78 million during 2013, an increase of \$42 million from 2012. Commercial mortgage banking operations contributed \$23 million during 2013, an increase of \$22 million from 2012. For both the residential and commercial mortgage banking operations, the increases were primarily driven by growth in transactional volumes. During 2013 we purchased \$7.11 billion of residential loans and originated \$659 million of commercial senior loans. During 2012 we purchased \$1.31 billion of residential loans and originated \$24 million of commercial senior loans. We did not recognize income or loss on mortgage banking activities in 2011.

Additional detail on mortgage banking activities is included in the Residential Mortgage Banking and Commercial Mortgage Banking and Investment portions of the *Segment Results* section below.

MSR Income, Net

MSR income is comprised of both the net cash received from the MSRs and their market value changes. MSR income, net increased to \$20 million in 2013 from negative \$1 million in 2012. In 2013, MSR income was comprised of \$8 million of net cash income and \$12 million of positive market valuation changes. The overall increase in MSR income was due to the acquisition of \$48 million of MSR investments during the year as well as increases in their market value primarily driven by increased mortgage rates during 2013. In 2012, MSR loss was comprised of \$1 million of net cash income, offset by \$2 million of negative market valuation adjustments. We did not own any MSR investments in 2011.

Additional detail on MSR investments is included in the Residential Investments portion of the *Segment Results* section below.

Other Market Valuation Adjustments, Net

In 2013, the \$6 million of negative other market valuation adjustments primarily resulted from \$4 million of negative market value changes of trading securities and \$2 million of other-than-temporary impairments of AFS securities, each in our Residential Investments segment at Redwood. In 2012, the \$2 million of positive other market valuation adjustments primarily resulted from \$6 million of net positive valuation adjustments from Legacy Consolidated assets, partially offset by \$3 million of negative market valuation adjustments on securities at Redwood.

In 2011, the \$40 million of negative other market valuation adjustments were comprised of \$29 million of negative adjustments at Redwood and \$11 million of negative adjustments at Legacy Consolidated Entities. The adjustments at Redwood primarily resulted from negative valuation changes on derivatives used to hedge loans accumulated for the two securitizations we completed in 2011 as well as other-than-temporary impairments of AFS securities.

Table of Contents**Index to Financial Statements***Realized Gains, Net*

In 2013, realized gains, net, of \$25 million primarily resulted from the sale of \$176 million of AFS securities during the year. Realized gains of \$55 million during 2012 resulted primarily from the sale of \$167 million of AFS securities for a net realized gain of \$32 million and also included \$22 million of gains from the deconsolidation of certain Legacy Consolidated Entities during 2012. Realized gains of \$11 million during 2011 resulted primarily from the sale of AFS securities at Redwood for a net realized gain of \$9 million.

For additional detail on realized gains at Redwood, see the Residential Investments portion of the *Segment Results* below.

Operating Expense

In 2013, operating expense increased \$20 million to \$85 million. The increase in operating expenses was primarily driven by the additional costs associated with the expansion of our residential and commercial mortgage banking operations. This expansion included the opening of our Denver office in 2013, as well as an increase in overall headcount to 141 at December 31, 2013, from 86 at December 31, 2012. In 2012, operating expense increased \$17 million to \$65 million primarily due to a \$17 million increase in compensation expense compared to 2011. The majority of the compensation expense increase was from variable compensation, which increased year-over-year as the company's financial performance improved.

Other Expense

Other expense represents a \$12 million reserve we established in the fourth quarter of 2013 related to previously disclosed litigation regarding certain legacy Sequoia securitizations. For additional detail on pending litigation matters, refer to *Legal Proceedings* in Part II, Item 3 of this Annual Report on Form 10-K and Note 15 in Part II, Item 8 of this Annual Report on Form 10-K.

Provision for Income Taxes

In 2013, provision for income taxes increased \$10 million to \$11 million. The increase in income tax expense was primarily driven by higher income from both residential and commercial mortgage banking operations during 2013, which are performed in taxable REIT subsidiaries. Additional detail on provision for income taxes is included in the *Taxable Income* section below.

Net Interest Income

The following table presents the components of net interest income on a consolidated basis for the years ended December 31, 2013, 2012, and 2011.

Table 5 *Net Interest Income Consolidated*

	Year Ended December 31,		
	2013	2012	2011

(Dollars in Millions) ⁽¹⁾	Interest Income/ (Expense)	Average Balance ⁽²⁾	Yield (%)	Interest Income/ (Expense)	Average Balance ⁽²⁾	Yield (%)	Interest Income/ (Expense)	Average Balance ⁽²⁾	Yield (%)
Interest Income									
Residential loans	\$ 67	\$ 2,803	2.4	\$ 82	\$ 3,575	2.3	\$ 81	\$ 3,913	2.1
Commercial loans	43	382	11.4	27	246	10.9	9	89	9.9
Trading securities	25	118	20.9	37	262	14.0	42	301	14.1
Available-for-sale securities	91	1,036	8.8	86	860	10.0	85	650	13.0
Cash and cash equivalents	0	155	0.1	0	143	0.0	0	157	0.0
Total interest income	226	4,494	5.0	231	5,085	4.6	217	5,110	4.3
Interest Expense									
Short-term debt	(17)	989	(1.8)	(9)	487	(1.9)	(1)	57	(1.8)
ABS issued	(40)	2,188	(1.8)	(102)	3,504	(2.9)	(88)	3,954	(2.2)
Long-term debt	(24)	395	(6.0)	(10)	139	(6.9)	(10)	138	(6.9)
Total interest expense	(81)	3,571	(2.3)	(121)	4,130	(2.9)	(99)	4,148	(2.4)
Net Interest Income	\$ 145			\$ 111			\$ 118		

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

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

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Legacy Consolidated Entities contributed \$8 million, negative \$4 million, and \$11 million to net interest income in 2013, 2012, and 2011, respectively. These amounts are discussed in more detail in the *Results from Legacy Consolidated Entities* section below. The following table presents net interest Income at Redwood and does not include activity from Legacy Consolidated Entities.

Table 6 Net Interest Income at Redwood

	Year Ended December 31,								
	2013			2012			2011		
(Dollars in Millions) ⁽¹⁾	Interest Income/ (Expense)	Average Balance ⁽²⁾	Yield (%)	Interest Income/ (Expense)	Average Balance ⁽²⁾	Yield (%)	Interest Income/ (Expense)	Average Balance ⁽²⁾	Yield (%)
Interest Income									
Residential loans	\$ 33	\$ 823	4.1	\$ 15	\$ 392	3.9	\$ 11	\$ 238	4.6
Commercial loans	43	382	11.4	26	235	11.1	8	75	10.6
Trading securities	25	118	20.9	12	34	35.0	8	21	37.9
Available-for-sale securities	91	1,036	8.8	86	860	10.0	84	643	13.0
Cash and cash equivalents	0	155	0.1	0	125	0.0	0	132	0.0
Total interest income	192	2,513	7.7	139	1,646	8.4	111	1,109	10.0
Interest Expense									
Short-term debt	(17)	989	(1.8)	(9)	487	(1.9)	(1)	57	(1.8)
ABS issued	(14)	284	(4.9)	(6)	205	(2.9)	(3)	102	(2.5)
Long-term debt	(24)	395	(6.0)	(10)	139	(6.9)	(10)	138	(6.9)
Total interest expense	(55)	1,667	(3.3)	(25)	831	(3.0)	(13)	297	(4.4)
Net Interest Income at Redwood	\$ 137			\$ 114			\$ 98		

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

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

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The following table details how net interest income at Redwood changed as a result of changes in average investment balances (volume) and changes in interest yields (rate).

Table 7 Net Interest Income at Redwood Volume and Rate Changes

(In Millions) ⁽¹⁾	Change in Net Interest Income For the Years Ended December 31, 2013 and 2012		
	Volume	Rate	Total
Net Interest Income for the Year Ended December 31, 2012			\$ 114
Impact of Changes in Interest Income			
Residential loans	\$ 17	\$ 1	18
Commercial loans	16	1	17
Trading securities	29	(16)	13
Available-for-sale securities	18	(12)	5
Cash and cash equivalents	-	-	-
Net changes in interest income	80	(27)	53
Impact of Changes in Interest Expense			
Short-term debt	(10)	2	(8)
ABS issued	(2)	(6)	(8)
Long-term debt	(18)	3	(14)
Net changes in interest expense	(30)	(1)	(30)
Net changes in interest income and expense	51	(27)	23
Net Interest Income for the Year Ended December 31, 2013			\$ 137

(In Millions) ⁽¹⁾	Change in Net Interest Income For the Years Ended December 31, 2012 and 2011		
	Volume	Rate	Total
Net Interest Income for the Year Ended December 31, 2011			\$ 98
Impact of Changes in Interest Income			
Residential loans	\$ 7	\$ (3)	5
Commercial loans	17	1	18
Trading securities	5	(1)	4
Available-for-sale securities	28	(26)	2
Cash and cash equivalents	-	-	-
Net changes in interest income	57	(29)	28
Impact of Changes in Interest Expense			

Short-term debt	(8)	(1)	(8)
ABS issued	(3)	(1)	(3)
Long-term debt	-	-	-
Net changes in interest expense	(10)	(1)	(12)
Net changes in interest income and expense	46	(30)	17

**Net Interest Income for the Year Ended December 31,
2012**

\$ 114

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

Analysis of Changes in Net Interest Income at Redwood 2013 versus 2012

Net interest income at Redwood increased \$23 million to \$137 million in 2013. This increase was primarily driven by higher interest income, which increased \$53 million to \$192 million in 2013, resulting from increased average earning assets across each of our segments in 2013.

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Our residential mortgage banking segment contributed \$33 million of the increase in interest income, with \$18 million of the increase resulting from higher balances of loans held for sale or securitization during 2013 as we increased our acquisition volumes, and \$15 million of the increase resulting from higher balances of Sequoia IO securities retained and held by us during 2013.

Our commercial mortgage banking and investments segment contributed \$17 million of the increase, with \$14 million resulting from higher average balances of loans held-for-investment, as we added to our portfolio throughout 2012 and 2013, and \$3 million from higher balances of senior loans held-for-sale during 2013 as we significantly increased our commercial mortgage banking activities.

Our residential investments segment contributed to \$3 million of the increase, as the benefits of higher average balances throughout 2013 were offset by lower yields. The decrease in yields was primarily related to lower unlevered yields available, in general, for new investments made in 2013 relative to investments acquired in prior years. In particular, during 2013, we acquired \$308 million of new residential investments that consist of AA, A, and BBB-rated RMBS securities with average unlevered yields of 4-6%. These securities were primarily acquired through Sequoia securitizations we sponsored as well as through third-party sponsored securitizations and represent more junior subordinate securities that we typically hold with equity and long-term debt capital.

IO securities that we retained from Sequoia securitizations issued during 2012 and 2013 are included in our Residential Mortgage Banking segment as they are used, in part, to mitigate certain risks associated with our residential mortgage banking activities. We have elected the fair value option for these securities and classify them as trading securities with changes in their estimated fair value recorded through our income statement in Mortgage banking activities, net and interest received on these securities reflected in Interest income. Rising interest rates during 2013 resulted in slower expected prepayment speeds for these securities, which increased their fair values, resulting in lower effective yields as presented in the tables above.

The increase from interest income was partially offset by higher interest expense at Redwood, which increased \$30 million to \$55 million in 2013. This increase in interest expense was generally attributable to our \$278 million of convertible debt that was issued in the first quarter of 2013, which contributed to \$13 million of the increase, and our Commercial Securitization that was completed in the fourth quarter of 2012, which contributed \$9 million of the increase. The remaining \$8 million of increases in interest expense were attributable to higher balances of short-term debt outstanding during 2013, primarily related to our residential mortgage banking activities. During 2013, the \$995 million of new investments made across all of our segments were funded in part with \$412 million of short-term debt.

Additional detail regarding the activities impacting net interest income at each of our business segments is included the *Segment Results* section below.

The following table presents the spread between the yield on unsecuritized loans and securities and their specific debt financing costs at December 31, 2013.

Table 8 Interest Expense Specific Borrowing Costs

December 31, 2013	Residential Loans	Residential Securities
-------------------	----------------------	---------------------------

Asset yield	4.09%	5.96%
Short-term debt yield	1.71%	1.34%
Net spread	2.38%	4.62%

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.

Analysis of Changes in Net Interest Income at Redwood 2012 versus 2011

Net interest income at Redwood increased \$17 million to \$114 million in 2012. This increase was primarily driven by higher interest income of \$28 million, resulting from increased average earning assets across each of our segments in 2012. This increase was partially offset by a decline in average yields on our investment securities that was primarily due to the change in mix of our investments from more credit sensitive, higher yielding securities to less credit sensitive, lower yielding securities.

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The increase from interest income was partially offset by higher interest expense, which increased \$12 million to \$25 million in 2012. This increase was primarily due to higher average short-term debt outstanding that was used to finance the higher balances of earning assets during 2012, as well as the securitization of \$291 million of commercial mezzanine loans in November 2012, where we sold \$172 million of senior debt. During 2012, the \$509 million of investments we purchased or retained from securitizations were funded in part with \$267 million of short-term debt.

Table of Contents**Index to Financial Statements****Segment Results**

The following is a discussion of the results of operations for our three business segments for the years ended December 31, 2013 and 2012. Our segments were determined as of December 31, 2013, and prior period results have been conformed to the current presentation. In 2011, our activities were almost exclusively within the residential investments segment. Accordingly, segment information is presented beginning with the 2012 fiscal year.

Residential Mortgage Banking

The following table presents the components of segment contribution for the residential mortgage banking segment for the years ended December 31, 2013 and 2012.

Table 9 Residential Mortgage Banking Segment Contribution

(In Thousands)	Year Ended December 31,	
	2013	2012
Interest income	\$ 52,517	\$ 19,714
Interest expense	(10,167)	(3,179)
Net interest income	42,350	16,535
Other market valuation adjustments, net	38	623
Mortgage banking activities, net	77,575	35,170
Direct operating expenses	(21,062)	(12,940)
Provision for income taxes	(5,947)	-
Segment Contribution	\$ 92,954	\$ 39,388

The following table provides the activity of unsecuritized residential loans during the years ended December 31, 2013 and 2012.

Table 10 Unsecuritized Residential Loans Activity

(In Thousands)	Year Ended December 31, 2013		Year Ended December 31, 2012	
	Fair Value Option	At Lower of Cost or Fair Value	Fair Value Option	At Lower of Cost or Fair Value
Balance at beginning of period	\$ 553,576	\$ 9,082	\$ -	\$ 395,237
Acquisitions	7,107,530	(27)	1,313,420	998,940
Sales	(7,229,896)	(5,747)	(794,456)	(1,370,048)
Principal repayments	(17,078)	(1,677)	(3,202)	(15,618)
Changes in fair value, net	(11,530)	34	37,814	571

Balance at End of Period \$ 402,602 \$ 1,665 \$ 553,576 \$ 9,082

The following table provides the activity of our retained Sequoia IO securities for the years ended December 31, 2013 and 2012.

Table 11 *Sequoia IO Securities Activity*

(In Thousands)	Year Ended December 31,	
	2013	2012
Beginning fair value	\$ 10,409	\$ -
Acquisitions	105,320	38,634
Sales	(48,633)	(16,523)
Change in fair value, net	43,409	(11,702)
Ending fair value	\$ 110,505	\$ 10,409

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Overview

During the year ended December 31, 2013, we acquired over \$7 billion in prime jumbo mortgage loans, completed 12 securitizations for a total of \$5.58 billion and sold \$1.6 billion through whole loan sales to third parties. In conjunction with these securitizations, we retained \$105 million of IOs in our Residential Mortgage Banking segment and \$298 million of subordinate securities and \$43 million of MSRs in our Residential Investment segment. At December 31, 2013, our pipeline of residential loans included \$403 million of residential loans held on balance sheet and \$589 million of loans identified for purchase.

Segment contribution from residential mortgage banking increased \$54 million to \$93 million in 2013, primarily resulting from increased loan acquisition volume, which totaled \$7.1 billion in 2013 as compared to \$2.3 billion in 2012. This increase in volume served to increase both net interest income as well as income from mortgage banking activities. These increases in income were partially offset by higher direct operating expenses and provision for income taxes.

Increased operating costs primarily resulted from expanding our infrastructure to facilitate the growth in mortgage banking operations, including the opening of our Denver office and increasing our headcount of employees now directly involved in this business. All residential mortgage banking activities are performed in taxable subsidiaries. Accordingly, increased income from this segment resulted in higher provision for income tax in 2013. The provision for income tax in 2013 was partially offset by a release of reserves on certain deferred tax assets during 2013. Going forward, we expect to incur a higher effective tax rate on our residential mortgage banking activities, closer to the 34% federal rate as we continue to benefit from state loss carryforwards.

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 IOs that are used to mitigate certain risks related to interest rate movements on our residential loan pipeline.

In 2013, our net interest income from loans held on balance sheet prior to sale was \$33 million and interest income from Sequoia IOs was \$19 million. The amount of net interest income we earn on loans held on balance 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. During 2013, we sold \$49 million of Sequoia IO securities, and we may sell additional Sequoia IOs in the future, which would reduce interest income in this segment.

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 residential loan pipeline. 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.

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The following table presents the components of mortgage banking activities, net from residential mortgage banking. Amounts presented below represent changes in market value 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 IOs outstanding as of the end of each year presented.

Table 12 Components of Residential Mortgage Banking Activities, Net⁽¹⁾

(In Thousands)	Year Ended December 31,	
	2013	2012
Changes in fair value of:		
Residential loans, at fair value	\$ (12,263)	\$ 37,762
Sequoia IO securities	42,451	(11,702)
Risk management derivatives	47,786	(10,604)
Purchase and forward sale commitments	(399)	-
Net gains on mortgage loan securitizations	-	17,931
Net gains on residential loan sales to third parties	-	1,783
Total Residential Mortgage Banking Activities, Net	\$ 77,575	\$ 35,170

(1) We elected the fair value option for held-for-sale residential loans purchased subsequent to June 30, 2012. Amounts reported as net gains on loan securitizations and sales to third parties for 2012 relate to the sale of loans held at the lower of cost or fair value that were purchased or originated prior to the dates we began to elect the fair value option for these loans 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.

Higher loan acquisition volume in 2013 contributed to a \$42 million increase in income from mortgage banking activities to \$78 million in 2013. While volatility in interest rates contributed to a net decline in the fair value of residential loans held-for-sale, this decrease in value was more than offset by increases in the value of risk management derivatives and Sequoia IOs that were used in part to hedge exposure to interest rate risk on these loans. The increase in fair value of Sequoia IOs in 2013 resulted from increases in current benchmark interest rates as well as the market expectation for higher interest rates in the future, resulting in lower expected prepayment speeds for the loans underlying these securities and higher valuations. However, given the significant increase in rates during the year, further increases in rates could have a more limited impact to the fair value of these securities. Additionally, decreases in current or expected future interest rates could cause decreases in the fair value of these securities, which would negatively impact income from mortgage banking activities in the future and could disproportionately impact profitability of this segment depending on the amount of loans in our pipeline and their interest rates relative to market interest rates at any point in time.

At the end of 2013, we had repurchase reserves of \$1.8 million outstanding, all of which were recorded in 2013 as a reduction to changes in the fair value of residential loans in Mortgage banking activities, net. As of December 31, 2013, there have been no loan-level repurchase claims made to Redwood where the entity that originated the loans in question was insolvent. 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 these loans by product type at December 31, 2013.

Table 13 *Characteristics of Unsecuritized Residential Loans*

December 31, 2013

(Dollars In Thousands)	Principal Value	Weighted Average Coupon
First Lien Prime		
Fixed - 30 year	\$ 278,776	4.36%
Fixed - 15 & 20 year	28,632	3.66%
Hybrid	91,974	3.42%
ARM	1,490	1.68%
Total Outstanding Principal	\$ 400,872	4.08%

During the second half of 2013, as mortgage rates were rising and overall mortgage loan volumes were falling, we began to see a greater amount of non 30-year fixed-rate loans originated, particularly hybrid loans. Whereas our acquisitions were almost entirely

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comprised of 30-year fixed-rate loans during the first half of 2013, in the second half of the year an increasing portion were non 30-year fixed-rate loans, as represented in the table above. We expect this trend to continue into 2014. In addition, during the fourth quarter of 2013, we began to acquire and sell conforming mortgage loans, purchasing \$17 million from our current active sellers and selling \$5 million to Fannie Mae and Freddie Mac. At the end of 2013, our loans held-for-sale included \$12 million of conforming loans and we had loan purchase commitment derivatives outstanding valued at \$380 thousand that were associated with commitments to purchase an additional \$43 million of conforming loans.

Residential Investments

Our residential investments segment is comprised of our residential securities portfolio and MSR portfolio. Sequoia IOs that are included as a component of senior prime 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.

The following table presents the components of segment contribution for the residential investments segment for the years ended December 31, 2013 and 2012.

Table 14 Residential Investments Segment Contribution

(In Thousands)	Year Ended December 31,	
	2013	2012
Interest income	\$ 96,399	\$ 93,266
Interest expense	(10,067)	(11,065)
Net interest income	86,332	82,201
Other market valuation adjustments, net	(5,134)	(5,228)
MSR income, net	20,309	(1,391)
Realized gains, net	24,765	32,451
Direct operating expenses	(4,035)	(5,711)
Provision for income taxes	(3,027)	-
Total Segment Contribution	\$ 119,210	\$ 102,322

The following table provides real estate securities activity in our residential investments segment for the years ended December 31, 2013 and 2012.

Table 15 Real Estate Securities Activity

(In Thousands)	Year Ended December 31,	
	2013	2012

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Beginning fair value	\$	1,098,344	\$	750,736
Acquisitions				
Sequoia securities		301,072		110,390
Third-party securities		488,599		358,720
Sales				
Sequoia securities		-		-
Third-party securities		(185,299)		(167,903)
Gains on sales and calls, net		24,765		32,451
Effect of principal payments		(147,602)		(119,245)
Change in fair value, net		(7,523)		133,195
Ending Fair Value	\$	1,572,356	\$	1,098,344

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The following table provides MSR activity in our residential investments segment for the years ended December 31, 2013 and 2012.

Table 16 MSR Activity

(In Thousands)	Year Ended December 31,	
	2013	2012
Balance at beginning of period	\$ 5,315	\$ -
Additions	47,514	7,329
Change in fair value, net	11,995	(2,014)
Balance at End of Period	\$ 64,824	\$ 5,315

Residential Securities Portfolio

During 2013, our residential securities portfolio increased \$474 million to \$1.57 billion, primarily driven by the acquisition of \$298 million of subordinate securities from Sequoia securitizations we issued during 2013, as well as \$131 million of net increases in senior securities and the acquisition of \$69 million of new-issue third-party subordinate securities. In 2013 we sold the remainder of our commercial securities. At December 31, 2013, the residential securities held (as a percentage of current market value) consisted of fixed-rate assets (39%), adjustable-rate assets (19%), hybrid assets that reset within the next year (27%), and hybrid assets that reset between 12 and 36 months (15%). Table 17 below provides detail for the activity in our securities portfolio by collateral type.

Net interest income from our securities portfolio increased \$4 million to \$86 million in 2013, primarily due to an increase in interest income resulting from higher average earning assets, which increased to \$1.05 billion in 2013 from \$883 million in 2012. 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 9.15% in 2013 from 10.57% in 2012. 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 at deeper discounts 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. Table 18 presents the composition of the portfolio by vintage and Table 19 provides additional detail on the yields by security type for our AFS securities portfolio.

Additionally, net interest income benefited from a \$1 million decrease in interest expense to \$10 million in 2013 that was primarily driven by a reduction in the average balance of the ABS debt outstanding on the Residential Resecuritization during 2013. The average balance of short-term debt used in part to fund our residential securities portfolio increased modestly in 2013, accompanying increases in average assets.

During 2013, we realized \$25 million of net gains on sales and calls of securities, primarily comprised of \$13 million of net gains from strategic sales of certain third-party senior and subordinate securities and \$12 million from the sale of the remainder of our commercial securities. 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.

During 2013, we recognized \$8 million of net changes in fair value related to our residential securities portfolio. Of this amount, \$6 million was recognized through the income statement in other market valuation adjustments, including \$4 million related to fair value changes for trading securities and \$2 million related to other-than-temporary impairments on securities in an unrealized loss position. The remaining \$2 million was recognized through accumulated comprehensive income on the balance sheet. Table 17 provides detail on the changes in fair value for securities by collateral type and Table 20 provides detail on cumulative gross gains and losses by collateral type.

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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 years ended December 31, 2013 and 2012.

Table 17 Real Estate Securities Activity by Collateral Type

Ended December 31, 2013 (Thousands)	Senior	Residential Re-REMIC ⁽¹⁾	Subordinate	Commercial	CDO	Total
Ending fair value	\$ 733,923	\$ 163,035	\$ 187,317	\$ 14,069	\$ -	\$ 1,098,354
Acquisitions						
Passive securities	3,403	-	297,669	-	-	301,072
Party securities	419,522	-	69,077	-	-	488,601
Dispositions						
Passive securities	-	-	-	-	-	-
Party securities	(163,986)	-	(7,244)	(14,069)	-	(185,300)
Net sales and calls, net	8,397	-	4,330	12,038	-	24,765
Net principal payments ⁽²⁾	(128,694)	-	(18,908)	-	-	(147,602)
Change in fair value, net	(7,803)	13,341	(1,023)	(12,038) ⁽³⁾	-	(7,523)
Ending Fair Value	\$ 864,762	\$ 176,376	\$ 531,218	\$ -	\$ -	\$ 1,572,364
Ended December 31, 2012 (Thousands)	Senior	Residential Re-REMIC ⁽¹⁾	Subordinate	Commercial	CDO	Total
Ending fair value	\$ 554,572	\$ 119,366	\$ 70,343	\$ 5,445	\$ 1,010	\$ 750,736
Acquisitions						
Passive securities	-	-	110,390	-	-	110,390
Party securities	327,492	26,135	5,093	-	-	358,720
Dispositions						
Passive securities	-	-	-	-	-	-
Party securities	(131,612)	(19,528)	(10,602)	(4,756)	(1,405)	(167,903)
Net sales and calls, net	16,917	10,636	1,339	3,272	287	32,491
Net principal payments ⁽²⁾	(106,332)	-	(12,913)	-	-	(119,245)
Change in fair value, net	72,886	26,426	23,667	10,108	108	133,200
Ending Fair Value	\$ 733,923	\$ 163,035	\$ 187,317	\$ 14,069	\$ -	\$ 1,098,354