REDWOOD TRUST INC
Form 10-Q
May 07, 2015
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UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: March 31, 2015

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 Incorporation or Organization)	(I.R.S. Employer Identification No.)
One Belvedere Place, Suite 300 Mill Valley, California	94941
(Address of Principal Executive Offices)	(Zip Code)

(415) 389-7373
(Registrant’s Telephone Number, Including Area Code)
Not Applicable
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer x Accelerated filer o Non-accelerated filer o Smaller reporting company o

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

Common Stock, $0.01 par value per share	84,257,726 shares outstanding as of May 4, 2015

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2015 FORM 10-Q REPORT
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

(Unaudited)	March 31, 2015	December 31, 2014
ASSETS [1]		
Residential loans, held-for-sale, at fair value	$1,094,885	$1,342,519
Residential loans, held-for-investment, at fair value [2]	2,304,870	2,056,054
Commercial loans, held-for-sale, at fair value	54,407	166,234
Commercial loans, held-for-investment (includes $72,619 and $71,262 at fair value)	405,935	400,693
Real estate securities, at fair value	1,285,243	1,379,230
Mortgage servicing rights, at fair value	120,324	139,293
Cash and cash equivalents	303,820	269,730
Total earning assets	5,569,484	5,753,753
Restricted cash	725	628
Accrued interest receivable	17,970	18,222
Derivative assets	30,546	16,417
Deferred securities issuance costs	14,302	16,050
Other assets	182,992	113,896
Total Assets	$5,816,019	$5,918,966
LIABILITIES AND EQUITY [1]		
Liabilities		
Short-term debt	$1,502,164	$1,793,825
Accrued interest payable	14,319	8,503
Derivative liabilities	68,064	58,331
Accrued expenses and other liabilities	60,135	52,244
Deferred tax liability	10,237	10,236
Asset-backed securities issued (includes $1,239,065 and $0 at fair value) [2]	1,353,021	1,545,119
Long-term debt (includes $68,707 and $66,707 at fair value)	1,550,869	1,194,567
Total liabilities	4,558,809	4,662,825
Equity		
Common stock, par value $0.01 per share, 180,000,000 shares authorized; 83,748,621and 83,443,141 issued and outstanding	837	834
Additional paid-in capital	1,779,777	1,774,030
Accumulated other comprehensive income	135,640	140,688
Cumulative earnings	931,396	906,867
Cumulative distributions to stockholders	(1,590,440)	(1,566,278)
Total equity	1,257,210	1,256,141
Total Liabilities and Equity	$5,816,019	$5,918,966

(1) Our consolidated balance sheets include assets of consolidated variable interest entities ("VIEs") that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At March 31, 2015 and December 31, 2014, assets of consolidated VIEs totaled $1,716,563 and $1,900,208, respectively, and liabilities of consolidated VIEs totaled $1,354,298 and $1,546,490, respectively. See Note 4 for further discussion.

(2) On January 1, 2015, we adopted ASU 2014-13 and began to account for residential loans held-for-investment and asset backed securities issued at consolidated Sequoia entities (which are VIEs) at fair value. At December 31, 2014, amounts presented in residential loans held-for-investment for these assets included $1,474,386 at historical cost. See Note 3 for further discussion.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data)	Three Months Ended March 31,	
(Unaudited)	2015	2014
Interest Income		
Residential loans	$25,009	$12,658
Commercial loans	10,914	10,384
Real estate securities	27,775	32,431
Cash and cash equivalents	48	3
Total interest income	63,746	55,476
Interest Expense		
Short-term debt	(7,224)	(3,827)
Asset-backed securities issued	(6,202)	(8,441)
Long-term debt	(10,535)	(6,792)
Total interest expense	(23,961)	(19,060)
Net Interest Income	39,785	36,416
Provision for loan losses	(206)	(1,284)
Net Interest Income After Provision	39,579	35,132
Non-interest Income		
Mortgage banking activities	1,923	(231)
Mortgage servicing rights income (loss)	(10,924)	606
Other market valuation adjustments (1)	(1,145)	(6,138)
Realized gains, net	4,306	1,092
Other income	809	—
Total non-interest income (loss)	(5,031)	(4,671)
Operating expenses	(25,063)	(19,971)
Net income before provision for income taxes	9,485	10,490
Benefit from income taxes	5,316	1,843
Net Income	$14,801	$12,333
Basic earnings per common share	$0.17	$0.14
Diluted earnings per common share	$0.16	$0.14
Regular dividends declared per common share	$0.28	$0.28
Basic weighted average shares outstanding	83,360,312	82,410,562
Diluted weighted average shares outstanding	85,622,216	84,940,540

(1) For the three months ended March 31, 2015, there were no other-than-temporary impairments. For the three months ended March 31, 2014, other-than-temporary impairments were $1,671, of which $113 were recognized through the Income Statement and $1,558 were recognized in Accumulated Other Comprehensive Income.

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

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

(In Thousands)	Three Months Ended March 31, 2015	
(Unaudited)	2015	2014
Net Income	$14,801	$12,333
Other comprehensive income:		
Net unrealized gain on available-for-sale securities	5,053	19,323
Reclassification of unrealized (gain) loss on available-for-sale securities to net income	(1,690)	1,298
Net unrealized (loss) gain on interest rate agreements	(8,442)	(8,795)
Reclassification of unrealized loss on interest rate agreements to net income	31	60
Total other comprehensive (loss) income	(5,048)	11,886
Total Comprehensive Income	$9,753	$24,219

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

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

For the Three Months Ended March 31, 2015

(In Thousands, Except Share Data)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
(Unaudited)	Shares	Amount					
December 31, 2014	83,443,141	$834	$1,774,030	$140,688	$906,867	$(1,566,278)	$1,256,141
Cumulative effect adjustment - adoption of ASU 2014-13 [1]	—	—	—	—	9,728	—	9,728
January 1, 2015	83,443,141	834	1,774,030	140,688	916,595	(1,566,278)	1,265,869
Net income	—	—	—	—	14,801	—	14,801
Other comprehensive loss	—	—	—	(5,048)	—	—	(5,048)
Issuance of common stock:							—
Dividend reinvestment & stock purchase plans	185,045	2	3,239	—	—	—	3,241
Employee stock purchase and incentive plans	120,435	1	(184)	—	—	—	(183)
Non-cash equity award compensation	—	—	2,692	—	—	—	2,692
Common dividends declared	—	—	—	—	—	(24,162)	(24,162)
March 31, 2015	83,748,621	$837	$1,779,777	$135,640	$931,396	$(1,590,440)	$1,257,210

For the Three Months Ended March 31, 2014

(In Thousands, Except Share Data)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
(Unaudited)	Shares	Amount					
December 31, 2013	82,504,801	$825	$1,760,899	$148,766	$806,298	$(1,471,005)	$1,245,783
Net income	—	—	—	—	12,333	—	12,333
Other comprehensive income	—	—	—	11,886	—	—	11,886
Issuance of common stock:							
Dividend reinvestment & stock purchase	77,660	1	1,544	—	—	—	1,545

plans							
Employee stock purchase and incentive plans	37,193	—	(783)	—	—	—	(783)
Non-cash equity award compensation	—	—	3,872	—	—	—	3,872
Common dividends declared	—	—	—	—	—	(23,749)	(23,749)
March 31, 2014	82,619,654	$826	$1,765,532	$160,652	$818,631	$(1,494,754)	$1,250,887

(1) On January 1, 2015, we adopted ASU 2014-13. See Note 3 for further discussion.

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

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

(In Thousands)	Three Months Ended March 31,	
(Unaudited)	2015	2014
Cash Flows From Operating Activities:		
Net income	$14,801	$12,333
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(9,176)	(9,158)
Depreciation and amortization of non-financial assets	143	106
Purchases of held-for-sale loans	(2,558,425)	(1,181,488)
Proceeds from sales of held-for-sale loans	2,455,452	785,380
Principal payments on held-for-sale loans	14,394	7,014
Net settlements of derivatives	(19,373)	(8,394)
Provision for loan losses	206	1,284
Non-cash equity award compensation expense	2,692	3,872
Market valuation adjustments	19,435	9,446
Realized gains, net	(4,306)	(1,092)
Net change in:		
Accrued interest receivable and other assets	(38,394)	(7,279)
Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities	3,476	(13,682)
Net cash used in operating activities	(119,075)	(401,658)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(7,600)	(32,998)
Principal payments on loans held-for-investment	101,754	70,800
Purchases of real estate securities	(15,613)	(49,709)
Proceeds from sales of real estate securities	77,293	—
Principal payments on real estate securities	26,313	42,304
Purchase of mortgage servicing rights	(5,173)	(928)
Proceeds from sales of mortgage servicing rights	17,235	—
Net increase in restricted cash	(97)	(34)
Net cash provided by investing activities	194,112	29,435
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	1,641,380	920,955
Repayments on short-term debt	(1,933,041)	(494,956)
Proceeds from issuance of asset-backed securities	420	—
Repayments on asset-backed securities issued	(80,918)	(88,523)
Deferred securities issuance costs	(32)	—
Proceeds from issuance of long-term debt	354,932	36,782
Repayments on long-term debt	—	(17)
Net settlements of derivatives	658	(721)
Net proceeds from issuance of common stock	134	122
Taxes paid on equity award distributions	(318)	(905)
Dividends paid	(24,162)	(23,749)
Net cash (used in) provided by financing activities	(40,947)	348,988
Net increase (decrease) in cash and cash equivalents	34,090	(23,235)
Cash and cash equivalents at beginning of period	269,730	173,201
Cash and cash equivalents at end of period	$303,820	$149,966
Supplemental Cash Flow Information:		

Cash paid during the period for:		
Interest	$15,032	$15,386
Taxes	38	1,399
Supplemental Noncash Information:		
Real estate securities retained from loan securitizations	$6,282	$—
Retention of mortgage servicing rights from loan securitizations and sales	15,675	2,294
Transfers from loans held-for-sale to loans held-for-investment	447,840	37,631
Transfers from residential loans to real estate owned	3,166	135

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2015
(Unaudited)

Note 1. Organization

Redwood Trust, Inc., together with its subsidiaries, focuses on investing in mortgage- and other real estate-related assets and engaging in residential and commercial mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential and commercial mortgage banking activities. We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. References herein to “Redwood,” the “company,” “we,” “us,” and “our” include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires.

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), beginning with its taxable year ended December 31, 1994. To qualify as a REIT, we must distribute at least 90% of our annual REIT taxable income to shareholders (not including taxable income retained in our taxable subsidiaries) within the time frame set forth in the tax code and also meet certain other requirements related to assets, income, and stock ownership. We 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.” We generally intend to distribute as dividends at least 90% of the taxable income we generate at our REIT.

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at March 31, 2015 and December 31, 2014, and for the three months ended March 31, 2015 and 2014. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with consolidated financial statements and notes thereto included in the company's Annual Report on Form 10-K for the year ended December 31, 2014. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at March 31, 2015 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2015 should not be construed as indicative of the results to be expected for the full year.

Principles of Consolidation

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

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Note 2. Basis of Presentation - (continued)

For financial reporting purposes, the underlying loans and securities owned at the consolidated Sequoia entities, the Residential Resecuritization entity, and the Commercial Securitization entity are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The asset-backed securities ("ABS") issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned at these entities and interest expense on the ABS issued by these entities.
See Note 4 for further discussion on principles of consolidation.

Use of Estimates

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

Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies

Included in Note 3 to the Consolidated Financial Statements of our 2014 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company's consolidated financial condition and results of operations for the three months ended March 31, 2015.

Recent Accounting Pronouncements

Adoption of ASU 2014-13

In November 2014, the FASB issued ASU 2014-13, "Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity" (ASU 2014-13). This update provides a measurement alternative to companies that consolidate collateralized financing entities ("CFEs"). Under the new guidance, companies can measure both the financial assets and financial liabilities of a CFE using the more observable of the fair value of the financial assets or fair value of the financial liabilities. This guidance is effective in the first quarter 2016 with early adoption permitted at the beginning of an annual period. The guidance can be applied either retrospectively to all relevant prior periods or by a modified retrospective approach with a cumulative-effect adjustment to equity as of the beginning of the annual period of adoption.

On January 1, 2015, we elected to early adopt ASU 2014-13, as we determined this measurement alternative more accurately reflects our economic interests in, and financial results from, certain consolidated financing entities. We adopted the measurement alternative under this standard only for our consolidated Sequoia entities, which qualify under the standard as CFEs. We did not elect the measurement alternative for our Residential Resecuritization or our Commercial Resecuritization, and will continue to account for the assets and liabilities in these CFEs in accordance with existing accounting guidance.

Under the provisions of ASU 2014-13, we use the fair value of the liabilities issued by the Sequoia CFEs (which we determined to be more observable) to determine the fair value of the assets, whereby the net assets we consolidate in our financial statements related to these entities represents the estimated fair value of our retained interests in the Sequoia CFEs. Similarly, the periodic net market valuation adjustments we record on our income statement from the consolidated assets and liabilities of the CFEs represents the change in fair value of our retained interests in the Sequoia CFEs.

Using the modified retrospective approach, we recorded a cumulative-effect adjustment to equity of $10 million through retained earnings as of January 1, 2015. This cumulative-effect adjustment represents the net effect of adjusting the assets and liabilities of the Sequoia CFEs from amortized historical cost to fair value.
Subsequent to the adoption of ASU 2014-13, the consolidated assets and liabilities of the Sequoia CFEs are both carried at fair value, with the periodic net changes in fair value recorded on our income statement, in Other market valuation adjustments.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2015
(Unaudited)

Note 3. Summary of Significant Accounting Policies - (continued)

The following table presents the assets and liabilities of the consolidated Sequoia entities at December 31, 2014 prior to the adoption of ASU 2014-13, the adjustments required to adopt the new standard, and the adjusted balances at January 1, 2015.

Impact of Adoption of ASU 2014-13 on Balance Sheet (1)

(In Millions)	December 31, 2014	ASU 2014-13 Adjustment	January 1, 2015
Loan Principal	$1,486	$(113)	$1,373
Loan unamortized premium	13	(13)	—
Allowance for loan losses	(21)	21	—
Residential loans held-for-investment	1,478	(105)	1,373
Deferred bond issuance costs	1	(1)	—
Other assets	5	—	5
Total assets	1,482	(105)	1,377
ABS issued principal	1,428	(125)	1,303
ABS issued unamortized discount	(10)	10	—
Total liabilities	1,418	(115)	1,303
Redwood's investment in consolidated Sequoia entities	$64	$10	$74

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

Other Recent Accounting Pronouncements

In April 2015, the FASB issued ASU 2015-03, “Simplifying the Presentation of Debt Issuance Costs.” This new guidance requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount. This new guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The new guidance is required to be applied on a retrospective basis. We plan to adopt this new guidance by the required date and will reclassify debt issuance costs that we currently present in other assets on our consolidated balance sheets and present them as debt discounts.

In February 2015, the FASB issued ASU 2015-02, “Consolidation (Topic 810) - Amendments to the Consolidation Analysis.” This new guidance provides a new scope exception for certain money market funds, makes targeted amendments to the current consolidation guidance, and ends the deferral granted to investment companies from applying the VIE guidance. This new guidance is effective for annual periods beginning after December 15, 2016. Early adoption is allowed, including in any interim period. We are currently evaluating the impact of adopting this new standard.

In June 2014, the FASB issued ASU 2014-11, “Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures.” This new guidance amends the accounting guidance for “repo-to-maturity” transactions and repurchase agreements executed as repurchase financings. In addition, the new standard requires a transferor to disclose more information about certain transactions, including those in which it retains substantially all of the exposure to the economic returns of the underlying transferred asset over the transaction’s term. This new guidance is effective in the first interim reporting period beginning after December 15, 2014. However, for repurchase and securities lending transactions reported as secured borrowing, the new standard’s enhanced disclosures are effective for annual periods beginning after December 15, 2014 and interim period beginning after March 15, 2015. We adopted the new guidance, as required, in the first quarter of 2015 and will adopt the disclosure requirements in the second quarter of 2015, as required. The adoption in the first quarter of 2015 did not have a material impact on our financial statements, as we did not have repo-to-maturity transactions outstanding.

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers.” The objective of the guidance is to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and IFRS. The Amendment supersedes most current revenue recognition guidance, including industry-specific guidance. The Amendment also enhances disclosure requirements

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 3. Summary of Significant Accounting Policies - (continued)

around revenue recognition and the related cash flows. The guidance is to be applied retrospectively to all prior periods presented or through a cumulative adjustment in the year of adoption, for interim and annual periods beginning after December 15, 2016. Early adoption is not permitted. We are currently evaluating the impact of adopting this new standard.

In January 2014, the FASB issued ASU 2014-04, "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure." This update to the receivable guidance clarifies when a creditor is considered to have received physical possession of residential real estate resulting from an in substance repossession or foreclosure. In addition, the amendments require disclosure of both: (i) the amount of foreclosed residential real estate property held by the creditor; and (ii) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The update requires the guidance to be applied using either a modified retrospective transition method or a prospective transition method for interim and annual periods beginning after December 15, 2014, with early adoption permitted. We adopted this standard in the first quarter of 2015, as required, and it did not have a material impact on our financial statements.

Balance Sheet Netting

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

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at March 31, 2015 and December 31, 2014.

Offsetting of Financial Assets, Liabilities, and Collateral

March 31, 2015 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet [1] Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets [2]						
Interest rate agreements	$17,554	$—	$17,554	$(2,719)	$(10,830)	$4,005
TBAs	4,721	—	4,721	(4,667)	(54)	—
Total Assets	$22,275	$—	$22,275	$(7,386)	$(10,884)	$4,005
Liabilities [2]						
Interest rate agreements	$(57,581)	$—	$(57,581)	$2,719	$54,862	$—
TBAs	(8,842)	—	(8,842)	4,666	3,201	(975)
Futures	(332)	—	(332)	—	332	—
Loan warehouse debt	(895,895)	—	(895,895)	895,895	—	—
Security repurchase agreements	(606,269)	—	(606,269)	606,269	—	—
Total Liabilities	$(1,568,919)	$—	$(1,568,919)	$1,509,549	$58,395	$(975)

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2015
(Unaudited)

Note 3. Summary of Significant Accounting Policies - (continued)

December 31, 2014 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet (1) Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets (2)						
Interest rate agreements	$7,006	$—	$7,006	$(1,160)	$(4,360)	$1,486
Credit default index swaps	1,598	—	1,598	—	(375)	1,223
TBAs	6,653	—	6,653	(5,815)	—	838
Total Assets	$15,257	$—	$15,257	$(6,975)	$(4,735)	$3,547
Liabilities (2)						
Interest rate agreements	$(48,173)	$—	$(48,173)	$1,160	47,013	$—
TBAs	(9,506)	—	(9,506)	5,815	2,715	(976)
Futures	(372)	—	(372)	—	372	—
Loan warehouse debt	(1,185,316)	—	(1,185,316)	1,185,316	—	—
Security repurchase agreements	(608,509)	—	(608,509)	608,509	—	—
Total Liabilities	$(1,851,876)	$—	$(1,851,876)	$1,800,800	$50,100	$(976)

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

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

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

Note 4. Principles of Consolidation

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

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Note 4. Principles of Consolidation - (continued)

Analysis of Consolidated VIEs
As of March 31, 2015, the VIEs we are required to consolidate include certain Sequoia securitization entities, the Residential Resecuritization entity, and the Commercial Securitization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.
Assets and Liabilities of Consolidated VIEs

March 31, 2015 (Dollars in Thousands)	Sequoia Entities	Residential Resecuritization	Commercial Securitization	Total
Residential loans, held-for-investment	$1,304,426	$—	$—	$1,304,426
Commercial loans, held-for-investment	—	—	191,575	191,575
Real estate securities	—	211,316	—	211,316
Restricted cash	147	—	135	282
Accrued interest receivable	1,720	449	1,491	3,660
Other assets	5,304	—	—	5,304
Total Assets	$1,311,597	$211,765	$193,201	$1,716,563
Accrued interest payable	$893	$10	$374	$1,277
Asset-backed securities issued	1,239,065	34,280	79,676	1,353,021
Total Liabilities	$1,239,958	$34,290	$80,050	$1,354,298
Number of VIEs	24	1	1	26

Analysis of Unconsolidated VIEs with Continuing Involvement
Since 2012, we have transferred residential loans to 23 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes, in accordance with ASC 860. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSRs on our consolidated balance sheets, and classified those MSRs as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets. Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSRs (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.
The following table presents information related to securitization transactions that occurred during the three months ended March 31, 2015 and 2014.
Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended March 31,	
(In Thousands)	2015	2014
Principal balance of loans transferred	$338,796	$—
Trading securities retained, at fair value	3,423	—
AFS securities retained, at fair value	2,859	—
MSRs recognized	1,872	—

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Note 4. Principles of Consolidation - (continued)

The following table summarizes the cash flows during the three months ended March 31, 2015 and 2014 between us and the unconsolidated VIEs sponsored by us.

Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended March 31,	
(In Thousands)	2015	2014
Proceeds from new transfers	$341,716	$—
MSR fees received	3,770	3,423
Funding of compensating interest	(90)	(33)
Cash flows received on retained securities	12,645	12,303

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

Assumptions Related to Assets Retained from Unconsolidated VIEs Sponsored by Redwood

	Issued During The Three Months Ended March 31, 2015	
At Date of Securitization	MSRs	Subordinate Securities
Prepayment rate	5 - 19 %	8 %
Discount rates	11 %	6 %
Credit loss assumptions	N/A	0.25 %

The following table presents additional information at March 31, 2015 and December 31, 2014, related to unconsolidated securitizations accounted for as sales since 2012.

Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	March 31, 2015	December 31, 2014
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	$69,258	$93,802
Senior and subordinate securities, classified as AFS	391,296	460,990
Maximum loss exposure (1)	460,554	554,792
Assets transferred:		
Principal balance of loans outstanding	7,287,906	7,276,825
Principal balance of delinquent loans 30+ days delinquent	20,952	17,022

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

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Note 4. Principles of Consolidation - (continued)

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at March 31, 2015 and December 31, 2014.

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

March 31, 2015 (Dollars in Thousands)	MSRs		Senior Securities		Subordinate Securities	
Fair value at March 31, 2015	$50,156		$65,809		$394,745	
Expected life (in years) (1)	6		6		11	
Prepayment speed assumption (annual CPR) (1)	17	%	11	%	10	%
Decrease in fair value from:						
10% adverse change	$2,329		$3,697		$905	
25% adverse change	5,530		7,035		2,356	
Discount rate assumption (1)	11	%	10	%	5	%
Decrease in fair value from:						
100 basis point increase	$1,645		$2,540		$30,841	
200 basis point increase	3,216		4,899		57,886	
Credit loss assumption (1)	N/A		0.25	%	0.25	%
Decrease in fair value from:						
10% higher losses	N/A		$345		$2,397	
25% higher losses	N/A		456		5,704	

December 31, 2014 (Dollars in Thousands)	MSRs		Senior Securities		Subordinate Securities	
Fair value at December 31, 2014	$56,801		$93,802		$460,990	
Expected life (in years) (1)	7		6		10	
Prepayment speed assumption (annual CPR) (1)	14	%	9	%	10	%
Decrease in fair value from:						
10% adverse change	$2,419		$3,999		$684	
25% adverse change	5,639		9,475		2,355	
Discount rate assumption (1)	11	%	8	%	5	%
Decrease in fair value from:						
100 basis point increase	$2,104		$4,214		$34,149	
200 basis point increase	4,102		8,091		64,474	
Credit loss assumption (1)	N/A		0.25	%	0.25	%
Decrease in fair value from:						
10% higher losses	N/A		$126		$3,169	
25% higher losses	N/A		299		7,841	

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

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Note 4. Principles of Consolidation - (continued)

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at March 31, 2015, grouped by security type.

Third-Party Sponsored VIE Summary

(Dollars in Thousands)	March 31, 2015
Residential Mortgage Backed Securities	
Senior	$480,200
Re-REMIC	169,240
Subordinate	175,250
Total Investments in Third-Party Sponsored VIEs	$824,690

We determined that we are not the primary beneficiary of any third-party VIEs, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise solely hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs – we only account for our specific interests in them.

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

Note 5. Fair Value of Financial Instruments

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

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

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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at March 31, 2015 and December 31, 2014.

	March 31, 2015		December 31, 2014	
(In Thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	$1,093,413	$1,093,413	$1,341,032	$1,341,032
At lower of cost or fair value	1,472	1,663	1,488	1,669
Residential loans, held-for-investment (1)				
At fair value	2,304,870	2,304,870	581,668	581,668
At amortized cost	—	—	1,474,386	1,381,918
Commercial loans, held-for-sale	54,407	54,407	166,234	166,234
Commercial loans, held-for-investment				
At fair value	72,619	72,619	71,262	71,262
At amortized cost	333,316	338,932	329,431	334,876
Trading securities	106,837	106,837	111,606	111,606
Available-for-sale securities	1,178,406	1,178,406	1,267,624	1,267,624
MSRs	120,324	120,324	139,293	139,293
Cash and cash equivalents	303,820	303,820	269,730	269,730
Restricted cash	725	725	628	628
Accrued interest receivable	17,970	17,970	18,222	18,222
Derivative assets	30,546	30,546	16,417	16,417
REO (2)	5,305	5,446	4,391	4,703
Margin receivable (2)	79,760	79,760	65,374	65,374
FHLBC stock (2)	28,434	28,434	10,688	10,688
Guarantee asset (2)	6,118	6,118	7,201	7,201
Pledged collateral (2)	10,265	10,265	9,927	9,927
Liabilities				
Short-term debt	$1,502,164	$1,502,164	$1,793,825	$1,793,825
Accrued interest payable	14,319	14,319	8,502	8,502
Guarantee obligation	6,917	6,917	7,201	7,201
Derivative liabilities	68,064	68,064	58,331	58,331
ABS issued (1)				
Fair value	1,239,065	1,239,065	—	—
Amortized cost	113,956	114,613	1,545,119	1,446,605
FHLBC borrowings	850,792	850,792	495,860	495,860
Commercial secured borrowings	68,077	68,077	66,707	66,707
Convertible notes	492,500	488,243	492,500	492,188
Other long-term debt	139,500	97,650	139,500	101,835

(1)

Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment and ABS issued by consolidated Sequoia entities began to be recorded at fair value. See Note 3 for further discussion.

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

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Note 5. Fair Value of Financial Instruments - (continued)

During the three months ended March 31, 2015, we elected the fair value option for $23 million of residential subordinate securities, $2.40 billion of residential loans (principal balance), $93 million of commercial loans (principal balance), and $19 million of MSRs, respectively. We anticipate electing the fair value option for all future purchases of residential loans and commercial senior loans that we intend to sell to third parties or transfer to securitizations as well as for MSRs purchased or retained from sales of residential loans.
The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at March 31, 2015, as well as the fair value hierarchy of the valuation inputs used to measure fair value.
Assets and Liabilities Measured at Fair Value on a Recurring Basis at March 31, 2015

March 31, 2015	Carrying	Fair Value Measurements Using		
(In Thousands)	Value	Level 1	Level 2	Level 3
Assets				
Residential loans	$3,398,283	$—	$200,869	$3,197,414
Commercial loans	127,026	—	—	127,026
Trading securities	106,837	—	—	106,837
Available-for-sale securities	1,178,406	—	—	1,178,406
Derivative assets	30,546	4,721	17,554	8,271
MSRs	120,324	—	—	120,324
Pledged collateral	10,265	10,265	—	—
FHLBC stock	28,434	28,434	—	—
Guarantee asset	6,118	—	—	6,118
Liabilities				
Derivative liabilities	68,064	9,173	58,045	846
Commercial secured borrowings	68,077	—	—	68,077
ABS issued	1,239,065	—	—	1,239,065

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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the three months ended March 31, 2015.

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

	Assets							Liabilities	
(In Thousands)	Residential Loans	Commercial Loans	Trading Securities	AFS Securities	MSRs	Guarantee Asset	Derivatives (1)	Commercial Secured Borrowings	ABS Issued
Beginning balance - December 31, 2014	$1,677,984	$237,496	$111,606	$1,267,624	$139,293	$7,201	$1,119	$66,707	$—
Transfer to FVO (2)	1,370,699	—	—	—	—	—	—	—	1,302,216
Principal paydowns	(111,716)	(240)	(203)	(26,110)	—	—	—	(152)	(66,517)
Amortization income	—	—	—	9,838	—	—	—	—	—
Gains (losses) in net income, net	7,570	7,366	(14,114)	4,306	(19,517)	(1,083)	20,087	1,509	2,946
Unrealized gains in OCI, net	—	—	—	3,795	—	—	—	—	—
Acquisitions	1,112,042	92,713	23,084	9,831	18,754	—	—	—	—
Sales	(857,249)	(210,309)	(13,536)	(90,878)	(18,206)	—	—	—	—
Other settlements, net	(1,916)	—	—	—	—	—	(13,781)	13	421
Ending balance - March 31, 2015	$3,197,414	$127,026	$106,837	$1,178,406	$120,324	$6,118	$7,425	$68,077	$1,239,066

(1) For the purpose of this presentation, derivative assets and liabilities, which consist of loan purchase commitments, are presented on a net basis.
(2) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment in, and ABS issued by, consolidated financial entities are now recorded at fair value. See Note 3 for further discussion.

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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at March 31, 2015 and 2014. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three months ended March 31, 2015 and 2014 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at March 31, 2015 and 2014 Included in Net Income

	Included in Net Income Three Months Ended March 31,	
(In Thousands)	2015	2014
Assets		
Residential loans at Redwood	$5,464	$3,483
Residential loans at consolidated Sequoia entities	1,179	—
Commercial loans	2,959	2,530
Trading securities	(13,790)	(4,431)
Available-for-sale securities	—	(113)
MSRs	(11,769)	(2,291)
Loan purchase commitments	7,422	—
Other assets - Guarantee asset	(1,083)	—
Liabilities		
Loan purchase commitments	—	(235)
Commercial secured borrowing	(1,509)	—
ABS issued	(2,946)	—

The following table presents information on assets recorded at fair value on a non-recurring basis at March 31, 2015. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at March 31, 2015.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at March 31, 2015

March 31, 2015	Carrying	Fair Value Measurements Using			Gain (Loss) for Three Months Ended
(In Thousands)	Value	Level 1	Level 2	Level 3	March 31, 2015
Assets					
Residential loans, at lower of cost or fair value	$1,103	$—	$—	$1,103	$—
REO	3,410	—	—	3,410	(74)

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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the three months ended March 31, 2015 and 2014.

Market Valuation Adjustments, Net

	Three Months Ended March 31,	
(In Thousands)	2015	2014
Mortgage banking activities		
Residential loans, at fair value	$2,056	$7,128
Commercial loans, at fair value	5,857	3,626
Sequoia IO securities	(14,359)	(4,277)
Risk management derivatives, net	(10,583)	(7,082)
Loan purchase and forward sale commitments	18,256	8
Total mortgage banking activities(1)	1,227	(597)
MSRs	(19,517)	(2,711)
Other		
Residential loans, at lower of cost or fair value	$2	$(2)
Consolidated Sequoia entities (2)	(1,093)	—
Residential loans held-for-investment, at Redwood	1,978	—
Trading securities	270	(154)
Impairments on AFS securities	—	(113)
Other risk management derivative instruments, net	(1,374)	(5,727)
Guarantee asset	(1,083)	—
Other	155	(142)
Total other	(1,145)	(6,138)
Total Market Valuation Adjustments, Net	$(19,435)	$(9,446)

(1) Income from mortgage banking activities presented above does not include fee income or provisions for repurchases that is a component of mortgage banking income presented on our consolidated statements of income as these amounts do not represent a market valuation adjustment.

(2) On January 1, 2015, we adopted ASU 2014-13 and began to record the assets and liabilities of consolidated Sequoia entities at fair value. This amount represents the net change in fair value of the consolidated assets and liabilities of these entities, which include residential loans held-for-investment, REO, and ABS issued. This amount also represents the estimated change in value of our retained interests in these entities. See Note 3 for further discussion.

At March 31, 2015, our valuation policy and process had not changed from those described in our Annual Report on Form 10-K. The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

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Note 5. Fair Value of Financial Instruments - (continued)

Fair Value Methodology for Level 3 Financial Instruments

March 31, 2015 (Dollars in Thousands, except input values)	Fair Value	Unobservable Input	Range		Weighted Average	
Assets						
Residential loans, at fair value:						
Jumbo fixed rate loans priced to securitization or to whole loan market and uncommitted to sell	$1,334,594	IO Multiple	4.0 - 4.6	x	4.2	x
		Prepayment rate (Annual CPR)	12 - 15	%	14	%
		Senior spread to TBA price	$3.13 - 3.13		$3.13	
		Subordinate spread to swap rate	315 - 315	bps	315	bps
		Credit support	8 - 8	%	8	%
		Whole loan spread to TBA price	$3.10 - 4.50		$4.35	
Jumbo hybrid loans priced to whole loan market and uncommitted to sell	137,168	Prepayment rate (Annual CPR)	15 - 15	%	15	%
		Spread to swap rate	125 - 165	bps	134	bps
Jumbo loans priced to whole loan market and committed to sell	421,226	Committed Sales Price	$102 - 103		$103	
Loans held by consolidated Sequoia entities (1)	1,304,426	Liability price	N/A		N/A	
Residential loans, at lower of cost or fair value	1,103	Loss severity	13 - 30	%	20	%
Commercial loans, at fair value	127,026	Spread to swap rate	147 - 156	bps	154	bps
		Credit support	22 - 23	%	23	%
Trading and AFS securities	1,285,243	Discount rate	4 - 12	%	6	%
		Prepayment rate (Annual CPR)	1 - 35	%	12	%
		Default rate	0 - 35	%	8	%
		Loss severity	20 - 64	%	34	%
		Credit support	0 - 48	%	10	%

MSRs	120,324	Discount rate	9 - 11	%	10	%
		Prepayment rate (Annual CPR)	4 - 60	%	14	%
		Per loan annual cost to service	$ 72 - 82		$77	
Guarantee asset	6,118	Discount rate	11 - 11	%	11	%
		Prepayment rate (Annual CPR)	5 - 27	%	12	%
REO	3,410	Loss severity	31 - 66	%	46	%
Loan purchase commitments, net (2)	7,425	MSR Multiple	0.0 - 5.7	x	3.5	x
		Fallout rate	2 - 98	%	33	%
Liabilities						
ABS issued by consolidated Sequoia entities (1)	1,239,065	Discount rate	4 -8	%	5	%
		Prepayment rate (Annual CPR)	0 - 31	%	13	%
		Default rate	0 - 12	%	6	%
		Loss severity	20 - 32	%	26	%
		Credit support	0 - 65	%	11	%
Commercial secured financing	68,077	Spread to swap rate	156 - 156	bps	156	bps
		Credit support	23 - 23	%	23	%

(1) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment in, and ABS issued by, consolidated Sequoia entities began to be recorded at fair value. In accordance with this new guidance, the fair value of the loans in these entities were based on the fair value of the liabilities issued by these entities, which we determined were more readily observable. See Note 3 for further discussion.
(2) For the purpose of this presentation, loan purchase commitment assets and liabilities are presented net.

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Note 5. Fair Value of Financial Instruments - (continued)

Determination of Fair Value
A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed herein. We generally use both market comparable information and discounted cash flow modeling techniques to determine the fair value of our Level 3 assets and liabilities. Use of these techniques requires determination of relevant inputs and assumptions, some of which represent significant unobservable inputs as indicated in the preceding table. Accordingly, a significant increase or decrease in any of these inputs – such as anticipated credit losses, prepayment rates, interest rates, or other valuation assumptions – in isolation would likely result in a significantly lower or higher fair value measurement.
Residential loans
Estimated fair values for residential loans are determined based on either an exit price to securitization or the whole loan market. For loans valued based on an exit to securitization, significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the limited availability of market quotes on newly issued RMBS and related inputs. Relevant market indicators that are factored into the analyses include third-party RMBS sales and pricing points for secondary sales of RMBS we have issued in past periods (which both provide indicative spreads to indexed TBA prices for senior securities and indexed swap rates for subordinate securities), as well as Agency RMBS, indexed swap yields, credit rating agency guidance on expected credit support levels for newly issued RMBS transactions, interest rates, and prepayment rates (Level 3). These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed or credit support assumptions.
For loans valued based on an exit to the whole loan market, significant inputs in the valuation analysis are predominantly Level 3 in nature. Relevant market indicators that are factored into the analyses include prices on recent sales of our own whole loans and third-party whole loan sales (which provide indicative spreads to indexed swap rates), indexed swap yields, interest rates, and prepayment rates (Level 3). These assets would generally decrease in value based upon an increase in the credit spread assumption.
Estimated fair values for conforming loans are determined based upon quoted market prices (Level 2). Conforming loans are mortgage loans that conform to Agency guidelines. As necessary, these values are adjusted for servicing value, market conditions and liquidity.
Commercial loans
Estimated fair values for senior commercial loans held-for-sale are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses include pricing points for current third-party Commercial Mortgage-Backed Securities (“CMBS”) sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for the securities for purchase into securitization (Level 2). The estimated fair value of our senior commercial loans would generally decrease based upon an increase in credit spreads or required credit support.
Estimated fair values for mezzanine commercial loans are determined by both market comparable pricing and discounted cash flow analysis valuation techniques (Level 3). Our discounted cash flow models utilize certain significant unobservable inputs including the underwritten net operating income and debt coverage ratio assumptions and actual performance relative to those underwritten metrics as well as estimated market discount rates. An increase in market discount rates would reduce the estimated fair value of the commercial loans.
Real estate securities

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

Note 5. Fair Value of Financial Instruments - (continued)

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at March 31, 2015, we received dealer price indications on 81% of our securities, representing 93% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were 2% lower than the aggregate average dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Derivative assets and liabilities

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

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

MSRs

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

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

FHLBC Stock

Our Federal Home Loan Bank (FHLB) member subsidiary is required to purchase Federal Home Loan Bank of Chicago (FHLBC) stock under a borrowing agreement between our FHLBC member subsidiary and the FHLBC. Under this agreement, the stock is redeemable at face value, which represents the carrying value and fair value of the stock (Level 1).

Guarantee Asset

The guarantee asset represents the estimated fair value of cash flows we are contractually entitled to receive related to our risk sharing arrangement with Fannie Mae. Significant inputs in the valuation analysis are Level 3, due to the nature of this instrument and the lack of market quotes. The fair value of the guarantee asset is determined using a discounted cash flow model, for which significant inputs include prepayment rates and market discount rate (Level 3). An increase in prepayment speed or market discount rate will reduce the estimated fair value of the guarantee asset.

Note 5. Fair Value of Financial Instruments - (continued)

Pledged Collateral

Pledged collateral consists of cash and U.S. Treasury securities held by a custodian in association with certain agreements we have entered into. Treasury securities are carried at their fair value, which is determined using quoted process in active markets
(Level 1).

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

REO

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

Margin receivable

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

Short-term debt

Short-term debt includes our credit facilities that mature within one year. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 1).

ABS issued

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

As part of our ABS issued valuation process, we also request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at March 31, 2015, we received dealer price indications on 36% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were 1% higher than the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis.

FHLBC Borrowings

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Note 5. Fair Value of Financial Instruments - (continued)

FHLBC borrowings include amounts borrowed from the FHLBC that are secured by residential mortgage loans. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 1).

Commercial secured borrowings

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

Convertible notes

Convertible notes include unsecured convertible and exchangeable senior notes. Fair values are determined using quoted prices in active markets (Level 2).

Trust preferred securities and subordinated notes

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

Note 6. Residential Loans

We acquire residential loans from third-party originators. The following table summarizes the classifications and carrying values of the residential loans owned at Redwood and at consolidated Sequoia entities at March 31, 2015 and December 31, 2014.

March 31, 2015			
(In Thousands)	Redwood	Sequoia (1)	Total
Held-for-sale			
Fair value - conforming	$200,869	$—	$200,869
Fair value - jumbo	892,544	—	892,544
Lower of cost or fair value	1,472	—	1,472
Held-for-investment			
Fair value - Jumbo	1,000,444	1,304,426	2,304,870
Total Residential Loans	$2,095,329	$1,304,426	$3,399,755

December 31, 2014			
(In Thousands)	Redwood	Sequoia (1)	Total
Held-for-sale			
Fair value - conforming	$244,714	$—	$244,714
Fair value - jumbo	1,096,317	—	1,096,317
Lower of cost or fair value	1,488	—	1,488
Held-for-investment			
Fair value - jumbo	581,668	—	581,668
At amortized cost	—	1,474,386	1,474,386
Total Residential Loans	$1,924,187	$1,474,386	$3,398,573

(1) Upon adoption of ASU 2014-13 on January 1, 2015, loans held-for-investment at consolidated Sequoia entities began to be recorded at fair value. See Note 3 for further discussion.

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Note 6. Residential Loans - (continued)

At March 31, 2015, we owned mortgage servicing rights associated with $1.91 billion of consolidated residential loans purchased from third-party originators. The value of these MSRs is included in the carrying value of the associated loans on our balance sheet. We contract with a licensed sub-servicer that performs servicing functions for these loans.

Residential Loans Held-for-Sale

Residential Loans at Fair Value

At March 31, 2015, we owned 1,903 held-for-sale loans with an unpaid principal balance of $1.07 billion, compared to 2,273 loans with an unpaid principal balance of $1.30 billion at December 31, 2014. At March 31, 2015 and December 31, 2014, none of these loans were greater than 90 days delinquent and none of the loans were in foreclosure.

During the three months ended March 31, 2015 and 2014, we purchased $2.40 billion and 1.07 billion (principal balance) of loans, respectively, for which we elected the fair value option and recorded $2 million and $7 million of positive valuation adjustments, respectively, on residential loans held-for-sale at fair value through mortgage banking activities, a component of our consolidated income statement. During the three months ended March 31, 2015 and 2014, we sold $2.20 billion and $707 million (principal balance) of loans held-for-sale, respectively.

Residential Loans at Lower of Cost or Fair Value

At March 31, 2015 and December 31, 2014, we held nine residential loans at the lower of cost or fair value with $2 million in outstanding principal balance and a carrying value of $1 million.

Residential Loans Held-for-Investment at Fair Value

Residential Loans at Redwood

During the three months ended March 31, 2015, we transferred loans with a principal balance of $436 million and a fair value of $448 million from held-for-sale to held-for-investment bringing the total amount of loans held-for-investment at fair value to $1.00 billion at March 31, 2015. At March 31, 2015, $994 million of these loans were pledged as collateral under a borrowing agreement with the FHLBC.

At March 31, 2015, we owned 1,314 held-for-investment loans at Redwood with an unpaid principal balance of $972 million, compared to 803 loans with an unpaid principal balance of $566 million at December 31, 2014. At March 31, 2015 and December 31, 2014, none of these loans were greater than 90 days delinquent and none of the loans were in foreclosure.

The outstanding loans held-for-investment at Redwood at March 31, 2015 were originated in 2014 and 2015 and the weighted average FICO score of borrowers backing these loans was 773 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 68% (at origination). At March 31, 2015, these loans were comprised of fixed-rate loans with a weighted average coupon of 3.92%, and hybrid loans with a weighted average coupon of 3.06%.

Residential Loans at Consolidated Sequoia Entities

On January 1, 2015, we eliminated $13 million of unamortized premium, net and $21 million of allowance for loan losses, related to loans at our consolidated Sequoia entities as part of our initial adoption of ASU 2014-13 and recorded a valuation adjustment on these loans to reduce the loan carrying values to their estimated fair values. See Note 3 for further discussion.

The following table details the carrying value for residential loans held-for-investment at consolidated Sequoia entities at March 31, 2015 and December 31, 2014.

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Note 6. Residential Loans - (continued)

(In Thousands)	March 31, 2015	December 31, 2014
Principal balance	$1,415,017	$1,483,213
Unamortized premium, net	—	12,511
Allowance for loan losses	—	(21,338)
Valuation adjustment	(110,591)	—
Carrying value	$1,304,426	$1,474,386

At March 31, 2015, we owned 5,177 held-for-investment loans at consolidated Sequoia entities, as compared to 5,315 loans at December 31, 2014. The weighted average FICO score of borrowers backing these loans was 733 (at origination) and the weighted average LTV ratio of these loans was 66% (at origination). At March 31, 2015 and December 31, 2014, the unpaid principal balance of loans at consolidated Sequoia entities delinquent greater than 90 days was $68 million and $73 million, respectively, and the unpaid principal balance of loans in foreclosure was $34 million and $39 million, respectively. During the three months ended March 31, 2015, we recorded positive $3 million of valuation adjustments on these loans through other market valuation adjustments on our consolidated statements of income.

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Note 7. Commercial Loans

We invest in commercial loans that we originate as well as loans that we acquire from third-party originators. The following table summarizes the classifications and carrying value of commercial loans at March 31, 2015 and December 31, 2014.

(In Thousands)	March 31, 2015	December 31, 2014
Held-for-sale, at fair value	$54,407	$166,234
Held-for-investment		
At fair value	72,619	71,262
At amortized cost	333,316	