

REDWOOD TRUST INC  
Form 10-K  
March 05, 2008

**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, 2007**

**OR**

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

**For the transition period from to  
Commission file number 1-13759**

**REDWOOD TRUST, INC.**

(Exact Name of Registrant as Specified in Its Charter)

(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)

Securities Registered Pursuant to Section 12(g) of the Act:

Title of Each Class:

**Common Stock, par value \$0.01 per share**

Name of Exchange on Which Registered:

**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 Exchange 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) 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 or a non-accelerated filer.

See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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, 2007, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$1,345,747,756 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 March 4, 2008 was 32,608,498.

# 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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## TABLE OF CONTENTS

### REDWOOD TRUST, INC.

### 2007 FORM 10-K REPORT

### TABLE OF CONTENTS

PART I		
<u>Item 1.</u>	<u>Business</u>	<u>1</u>
<u>Item 1A.</u>	<u>Risk Factors</u>	<u>6</u>
<u>Item 1B.</u>	<u>Unresolved Staff Comments</u>	<u>23</u>
<u>Item 2.</u>	<u>Properties</u>	<u>23</u>
<u>Item 3.</u>	<u>Legal Proceedings</u>	<u>23</u>
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>	<u>23</u>
PART II		
<u>Item 5.</u>	<u>Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities</u>	<u>-</u>
<u>Item 6.</u>	<u>Selected Financial Data</u>	<u>24</u>
<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>-</u>
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>27</u>
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	<u>86</u>
<u>Item 9.</u>	<u>Changes and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>89</u>
<u>Item 9A.</u>	<u>Controls and Procedures</u>	<u>89</u>
<u>Item 9B.</u>	<u>Other Information</u>	<u>91</u>
PART III		
<u>Item 10.</u>	<u>Directors and Executive Officers of the Registrant</u>	<u>92</u>
<u>Item 11.</u>	<u>Executive Compensation</u>	<u>92</u>
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management</u>	<u>92</u>
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions</u>	<u>92</u>
<u>Item 14.</u>	<u>Principal Accounting Fees and Services</u>	<u>92</u>
PART IV		
<u>Item 15.</u>	<u>Exhibits, Financial Statement Schedules</u>	<u>93</u>
	<u>Consolidated Financial Statements</u>	<u>F-1</u>

TABLE OF CONTENTS

## **PART I**

### **ITEM 1. BUSINESS**

#### **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 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 forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in 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 Securities and Exchange Commission (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.

Important factors, among others, that may affect our actual results include: changes in interest rates; changes in prepayment rates; general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the availability of high quality assets for purchase at attractive prices; declines in home prices; increases in mortgage payment delinquencies; changes in the level of liquidity in the capital markets which may adversely affect our ability to finance our real estate asset portfolio; changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets, rating agency downgrades of securities and increases in the supply of real estate securities available-for-sale, each of which may adversely affect the values of securities we own; the extent of changes in the values of securities we own and the impact of adjustments reflecting those changes on our income statement and balance sheet, including our stockholders' equity; our ability to maintain the positive stockholders' equity necessary to enable us to pay the dividends required to maintain our status as a real estate investment trust for tax purposes; 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.

#### **Redwood Trust, Inc.**

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires.

#### **Business Model, Strategy, and Competition**

Redwood Trust is a financial institution with competitive advantages in the business of investing in real estate loans and securities. Since Redwood was founded in 1994, our goal has been to create a company that is more efficient than banks, thrifts, insurance companies, and other financial institutions at investing in, financing, and managing residential and commercial real estate loans and securities.

Like many financial institutions, our primary source of income is net interest income, which equals the interest income we earn from our investments in loans and securities less the interest expenses we incur from borrowed funds and other liabilities.

Some financial institutions fund their asset investments with borrowed money sourced by taking bank deposits, writing insurance policies, or issuing corporate debt. By contrast, we fund most of our investments with equity. Our investments are sourced from third party issuers of securitizations as well as the two securitization programs we sponsor, Sequoia and Acacia. Sequoia primarily acquires prime residential mortgage loans and creates and issues securities backed by these loans (ABS). Acacia is a collateralized debt obligation (CDO) program that acquires diverse residential and commercial mortgage-backed securities and creates and issues CDO ABS. Most of the securities created and sold by these entities earn the highest credit

1

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## TABLE OF CONTENTS

rating of AAA, so the interest expense paid out is relatively low compared to lower rated securities. Our investment in the securities we acquire from these entities generally earn the difference in the yield on the securitized assets less the interest expense payments made to the holders of the ABS securities sold. While our investments generally take the first credit losses on the underlying assets, our losses are limited to our investment in each entity.

As a long-term trend, we believe advances in securitization technology have enabled securitization to become increasingly competitive as a funding source relative to corporate debt, deposits, insurance contracts, and other borrowings. With the exception of recent months when capital markets have been in the midst of a liquidity crisis, the cost of funds for ABS securities issued has continued to improve relative to the cost of other borrowings. More importantly, until recently the range of assets that could be efficiently securitized continued to broaden and the capital efficiency of securitization as a source of funding continued to improve. Once the losses inherent in existing ABS are realized and the economy begins to improve, we expect securitization opportunities will return. As global capital markets continue to develop and evolve, we expect securitization to become an even more efficient source of funding in the long-run. There are trillions of dollars of real estate loans and securities in the U.S. and the world, and the amount outstanding has been and is expected to continue to grow every year. We believe many of these assets will be financed more efficiently through securitization than through other means. In addition, we do not believe that there are sufficient deposits in the banking system to fund all the real estate and other assets that require funding, so we believe securitization is a necessary part of our financial system on an on-going basis. Since we provide capital to credit-enhance mortgage loans and securities that are securitized by others and the securitization programs we sponsor, we believe we will be able to continue to grow and diversify our business over the long-term.

We also borrow money on a collateralized and uncollateralized basis, typically at very competitive rates. We do not, however, take deposits or raise money in any other way that would subject us to consumer lending or banking regulations. Since we are not regulated as a financial institution and do not deal directly with consumers, our operating costs are far lower than other financial institutions, and we have far greater freedom to use securitization as a source of funding.

Our tax structure gives us an additional competitive advantage that cannot be easily replicated by most other financial institutions. We have structured our company for tax purposes as a real estate investment trust (REIT) because our primary business is investing in real estate assets. As a REIT, we are required to distribute 90% or more of our taxable income as dividends. By doing so, we avoid paying corporate taxes on most of the income we generate. This lowers our costs, as taxes are one of the largest costs of doing business for most financial institutions.

In terms of capital employed, our largest area of investment is real estate credit-enhancement securities. Typically, 1% to 15% of the principal value of the securities created in a securitization of real estate assets are credit-enhancement

securities (CES). These securities bear most of the credit risk with respect to the underlying assets that were securitized. If the underlying loans or securities suffer a loss of principal due to default, that loss is passed on by reducing the principal value of the CES. As a result of the high level of assumed credit risks, CES carry credit ratings that are below investment-grade. Because the CES absorb most or all of the credit risk that would normally be expected to occur, they reduce the credit risk of the more senior securities, allowing them to earn investment-grade ratings and to be sold at higher prices.

We are a leading investor in CES issued from securitizations of prime-quality residential real estate loans and in 2005 and 2006 we were an increasingly important investor in CES issued from securitizations of commercial real estate loans made on income-producing properties. In recent years, we also made small investments in CES issued from securitizations of alt-a and subprime quality residential loans. In 2007, as a result of market conditions, we significantly reduced our level of acquisitions of residential and commercial CES. In total, at December 31, 2007, we owned residential, commercial, and CDO CES with a principal value of \$2.5 billion and a market value of \$749 million. Many of these securities are deep discount securities where our cost is far less than the principal value. Since we receive interest payments based on the principal value of a CES security, our interest income cash flow returns are strong. In addition, if credit losses are low, we will receive principal payments in excess of our cost basis, thus generating additional investment returns.

2

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## TABLE OF CONTENTS

Conversely, larger than expected credit losses could rapidly reduce the principal value of our CES, causing our investment returns from CES to suffer.

At December 31, 2007, our CES were first in line to absorb credit losses from \$250 billion of residential real estate loans and securities and \$62 billion of commercial real estate loans and securities that underlie the securitizations from which our CES investments were issued. However, our potential losses are far smaller and are limited to the purchase price of the CES in our portfolio.

With respect to these CES investments, we have a high degree of structural leverage since the principal value of our CES equals only a small percentage of the underlying asset pools. We do not, however, use a high degree of financial leverage with respect to our CES assets. We use capital (equity plus long-term subordinated debt) rather than debt to finance most of our investments in the more junior subordinated CES (the first-loss and second-loss securities, or equivalent) and we have been using capital plus securitization financing through our Acacia CDO issuance program to finance the more senior CES that are closer to investment-grade quality.

In the near term, we anticipate that our net growth in CES assets will be focused in newly originated prime-quality residential assets and on distressed prime, alt-a, and subprime residential securitizations and CDOs acquired at a substantial discount. Later in 2008, we believe acquisition opportunities in commercial real estate assets may become attractive. We expect to fund these acquisitions with equity capital.

We have begun raising third party capital through a Redwood sponsored opportunity fund that will invest in distressed asset opportunities that we see in the marketplace. Due to the accelerating pace of forced asset sale liquidations, primarily ABS CDO unwinds, we feel that opportunity investments can produce attractive risk adjusted returns for Redwood that supplement our core business initiatives. Our subprime and CDO structuring and investment expertise gives us a competitive advantage in evaluating such distressed asset opportunities. As the Redwood Opportunity Fund, LP manager, we will be entitled to management fees that could become substantial income streams in the future. We allocated \$50 million of capital to the Redwood Opportunity Fund, LP during the fourth quarter, and have currently deployed \$22 million of this amount into Fund eligible investments. Capital contributions to future opportunity funds will be based upon portfolio diversification, our ability to realize management fee income, and our assessment of risk

adjusted returns.

In the second half of 2007, capital markets turmoil increased the cost of issuing mortgage-backed and CDO securities, so our two securitization programs (Acacia and Sequoia) cut back significantly on their purchases and creation of loans and securities. We do not currently anticipate that Acacia will complete any new CDO securitizations in 2008, although it is possible market conditions for these CDO activities could improve towards year-end. We do anticipate Sequoia will acquire loans and issue ABS in 2008, although it is possible that market conditions for these types of securitizations will not improve enough to enable Sequoia to issue any new ABS on a profitable basis.

In 2007, we also acquired AAA-rated investment-grade residential securities with the intention of funding them on an on-going basis with short-term debt. Our goal was to seed the growth of an externally-managed REIT to be managed by Redwood that would pursue this strategy. As the liquidity crisis hit the capital markets in 2007, we sold these securities at a small loss. Going forward, it appears that such an externally-managed REIT may be viable, especially to the extent that assets are largely limited to agency (FNMA and FHLMC) residential mortgage securities. We may seek to develop such a REIT in 2008 or 2009 as part of our strategy of increasing our third-party asset management business.

We buy most of our assets rather than originate them. Our primary strategy for sourcing assets is for us (or the securitization entities we sponsor) to acquire loans and securities directly from other financial institutions or from the capital markets. We do not originate or service loans. Most of the real estate securities we invest in are created by others, some are created by us, but in both cases the underlying loans have been originated by others. This role allows us to have an independent point of view on asset quality and attractiveness, as well as the flexibility to change investment strategies as markets evolve. In our experience over the years, many financial institutions that have origination operations have produced sub-optimal asset investment results. We believe this is because, in some cases, there may have been incentives to retain loans that might not be the best investment (in terms of price and/or quality) in order to maintain or boost

3

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## TABLE OF CONTENTS

origination volumes and fees. In addition, origination (especially residential loan origination) is a business that is highly cyclical, operations intensive, and increasingly fraught with lender liability. Residential origination is becoming concentrated in the hands of a few large companies that have either banking or brokerage operations as well. Rather than competing with these companies, we develop close relationships with them and help them build their businesses. They need companies like Redwood (and the securitization programs we sponsor) to buy their loans and securities and credit-enhance their securitizations.

We previously built a successful commercial real estate loan origination operation at Redwood, and we may do so again in the future. We may also build a commercial real estate loan special servicing operation. Overall, in the long-run, we intend to build an integrated and diversified commercial real estate investment and specialty finance business. It is not yet clear to us, in light of increasing stress in the commercial real estate markets and the difficult market for commercial real estate CDO financing, what the best model will be for us to pursue with respect to commercial real estate finance in the future. We are in the process of recruiting new management for this business unit. In addition, in order to segregate our commercial business and possibly to finance and brand it separately in the future, we have contributed most of our commercial real estate assets to a wholly-owned subsidiary: Tanoak Commercial Capital Corporation.

We believe our operating efficiencies allow us to remain competitive. In addition, in times like these, when there are few asset buyers and potentially many sellers, and as a result asset prices decline, we benefit competitively from our strong balance sheet, minimal use of Redwood debt, cash balances, and access to new capital. Our competitors are

banks, thrifts, insurance companies, Fannie Mae, Freddie Mac, Wall Street brokerage firms, hedge funds, specialty finance companies, mortgage REITs, mortgage insurance companies, CDO securitization managers, asset management companies, foreign investors, and other financial institutions.

Our corporate structure and competitive strengths differ from most other financial institutions. With our differentiated capabilities, we interact as competitors, but also as customers and suppliers, with most of the institutions active in the vast and interconnected real estate capital markets.

We commenced operations in 1994, a period of turmoil in financial markets. This turmoil allowed us to acquire assets that produced very high returns in subsequent years. The level of competition increased dramatically through the end of 1997, at which time we generally sold assets, as the prospective risk/reward relationships for assets did not seem attractive. There were several financial dislocations in 1998, including a prepayment acceleration crisis and a liquidity crisis. This allowed us to use our excess capital to acquire assets, including our own stock, at attractive prices. The CES we acquired in 1999–2002 performed very well, allowing us to report high return on equity results and to pay special dividends of \$4.75 per share in 2003 and \$6.00 per share in 2004.

As the financial markets experience turmoil due to falling housing prices and rising residential loan defaults, we are and will increasingly incur increased credit losses but we are also in a good position to take advantage of the lower asset prices that have resulted. We believe competition for distressed asset acquisition opportunities will increase, however, but we also believe the magnitude and duration of extraordinary asset acquisition opportunities for the next year or two could be large relative to the supply of funds available to acquire these assets.

Through our internal risk-adjusted capital policies, we seek to maintain a strong balance sheet with a large capital base, risks that are limited and segregated, and ample liquidity.

We use capital, not debt, to fund assets such as first-loss credit-enhancement securities that carry concentrated credit risks. These assets have a high degree of structural credit risk, so we do not feel it would be prudent to employ financial leverage to acquire these assets. Our risk is limited to our investment in these securities. Since we fund these assets with capital rather than debt, high credit losses should not cause liquidity concerns.

We consolidate the assets and liabilities of Sequoia and Acacia. For these entities, our economic risk is limited to the value of any securities we may acquire as an investment from these entities. Our liquid reserves are secure with respect to these securitized assets consolidated on our balance sheet, since the assets were acquired by independent securitization entities, whose liabilities are not Redwood's obligations. Typically, we fund securities acquired from securitizations we sponsor with capital or we sell these securities to another securitization entity for re-securitization. In either case, the risk is segregated and limited.

4

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## TABLE OF CONTENTS

We have used Redwood debt to fund assets, and we may do so in the future. In the current environment, we expect to use capital (equity plus long-term subordinated debt) to fund most of our assets.

With respect to interest rate and prepayment rate risks, we seek to maintain a balance sheet that is well balanced and that can generate cash flows to fund our regular dividend in a wide variety of scenarios. We believe we have achieved this—the net present value of our projected cash flows does not vary materially with respect to scenarios incorporating changes in interest rates or prepayment rates. Scenarios incorporating different degrees of potential credit losses, however, show a wide variation in the long-term net present value of our cash flows. In the near-term (one to three years), our results may vary as a function of changes in interest rates, prepayments, credit results, mark-to-market asset values, and other factors.



Our primary financial goal is to distribute the highest levels of dividends per share over the next few decades as we can. We seek to do that while also remaining within our risk tolerance levels and while increasing the inherent value of the company by building competitive advantages, diversifying risks and opportunities, developing internal capabilities, maintaining our culture, keeping operations highly efficient, and increasing book value per share over time.

As a REIT, we are required to distribute to our shareholders as dividends at least 90% of our REIT profits as calculated for tax purposes. We distribute our profits as a regular quarterly dividend and also, in some years, in a year-end special dividend. The regular dividend rate for 2007 was \$0.75 per share per quarter and the special dividend was \$2.00 per share. Total dividends for 2007 were \$5.00 per share.

We expect the regular dividend to be \$0.75 per share per quarter for 2008, maintaining the same rate as in 2007. We set the regular dividend at a rate low enough so that we believe there is a relatively small chance that we would need to reduce it in the next few years. Whether we pay a special dividend or not in 2008 will depend primarily on how much REIT taxable income we generate during the year. We expect our total annual dividend payout amounts (regular plus special) will vary from year to year.

Profitable growth is our mission. In a manner consistent with our goal of distributing dividends per share in attractive amounts over time, our mission is to grow to become a larger company in terms of capital employed and market capitalization. We are targeting growth by building real estate investment, financing, and management operations with competitive advantages. Over the long term, growth should bring several advantages, including book value accretion and a diversified income stream.

We plan to grow organically as markets grow and as we gain long-term market share, rather than simply growing for growth's sake or through short-term acquisition of market share, which would be irresponsible and inconsistent with our long-term goal of distributing attractive dividends per share. But we do not expect growth to be linear, because in cyclical markets growth is not always the appropriate short-term strategy.

## **Information Concerning Redwood Trust**

Our website can be found at [www.redwoodtrust.com](http://www.redwoodtrust.com). We make available, free of charge on or through 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 pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after those materials are filed with, or furnished to, the SEC. We also make available, free of charge, access to our Code of Ethics, Corporate Governance Standards, Audit Committee Charter, Compensation Committee Charter, and Governance and Nominating Committee Charter.

## **Certifications**

Our Chief Executive Officer and Chief Financial Officer have executed certifications dated March 4, 2008, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, and we have included those certifications as exhibits to our Annual Report on Form 10-K for the year ended December 31, 2007. In addition, our Chief Executive Officer certified to the New York Stock Exchange (NYSE) on June 11, 2007 that he is 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, 2007, Redwood employed 99 people.

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TABLE OF CONTENTS**ITEM 1A. RISK FACTORS**

The following is a summary of the risk factors that we believe are most relevant to our business. These are factors which, individually or in the aggregate, we think could cause our actual results to differ significantly from anticipated or historical results. In addition to understanding the key risks described below, investors should understand that it is not possible to predict or identify all risk factors, and consequently, the following is not a complete discussion of all potential risks or uncertainties. We undertake no obligation to update forward-looking statements, whether as a result of new information, future events, or otherwise. Investors are advised, however, to consult any further disclosure we make in our reports on Forms 10-Q and 8-K filed with the SEC.

**Risks Related to our Business****Residential and commercial real estate loan delinquencies, defaults, and credit losses could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.**

We assume credit risk with respect to residential and commercial real estate loans primarily through the ownership of credit-enhancement securities (CES) backed by residential and commercial real estate loans, collateralized debt obligation (CDO) CES backed by residential and commercial securities, and through residential and commercial real estate loans. Residential and commercial CES have below investment-grade credit ratings and, correspondingly, a high degree of credit risk with respect to the residential and commercial real estate loans within the securitizations that issued these securities. We also assume credit risk through the residential, commercial, and CDO investment grade securities (which we refer to collectively as IGS) we own.

Credit losses on residential real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; increases in payments required to be made by borrowers; declines in the value of homes; earthquakes and other natural events; over-leveraging of the borrower; changes in legal protections for lenders; and personal events affecting borrowers, such as reduction in income, job loss, divorce or health problems. If the U.S. economy or the housing market continue to weaken, our credit losses could increase beyond levels that we originally anticipated or anticipate.

Rising interest rates may increase the credit risks associated with residential real estate loans. The interest rate is adjustable for most of the loans securitized by securitization entities we have sponsored and for a portion of the loans underlying residential and CDO CES 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 weakened U.S. economy. Moreover, many 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. Additional risks associated with commercial real estate loans are discussed below.

The IGS we hold also have credit-related risks. These assets initially received investment-grade ratings, but these initial ratings do not ensure that these securities will be free from credit losses, especially in a housing or economic downturn.

We attempt to manage these risks by periodically evaluating our investments for impairment indicators and establishing reserves for credit and other risks based upon our assessment of these risks. However, the amount of capital and cash reserves that we hold to help us manage credit and other risks may prove to be insufficient to protect us from earnings volatility, reductions or suspensions in regular dividends, and liquidity issues. If these increased credit losses are greater than we anticipated and we need to increase our credit reserves or in the event that assets which have declined in value are deemed to be other-than-temporarily

6

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## TABLE OF CONTENTS

impaired, our GAAP earnings might be reduced. Increased credit losses may also adversely affect our cash flows, dividend distribution requirements and payments, asset fair values, access to short-term borrowings, and our ability to securitize assets.

### **The nature of the securities we hold exposes us to concentrated credit risk that could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.**

Our residential and commercial CES have concentrated risks with respect to residential and commercial real estate loans, respectively. 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 the equity invested in the property) and, thereafter, by a cash reserve fund or letter of credit, if any, then by the first-loss CES holder, and then by holders of more senior CES. 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 will not be able to recover all of our principal 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 ABS, 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 CES or residential and commercial IGS) in which we invest (or have an indirect interest), which have effectively become the first-loss position behind the more senior securities.

### **The nature of the assets underlying some of the securities we hold could increase the credit risk of those securities, which, in turn, could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.**

For certain types of loans underlying our CES, the loan rate or borrower payment rate may increase over time, increasing the potential for default. For example, a portion of the securities we acquire, or have an indirect interest in through our investment in the Acacia entities we sponsor (sometimes collectively referred to as Acacia), are 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. This is particularly a

Residential and commercial real estate loan delinquencies, defaults, and credit losses could reduce our earnings, di

risk in a rising interest rate environment. Negative amortization occurs when the resulting excess 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 to which we are exposed, such as hybrid loans and teaser-rate adjustable-rate loans, may also have greater credit risk than more traditional mortgage loans.

**We credit-enhance commercial real estate loans and hold commercial CES, which may have significant credit and other risks that could adversely affect our business and operating results.**

The commercial real estate assets we own or in which we have an indirect interest through our investment in Acacia entities may be subject to significant credit and other risks, including environmental and legal risks. The net operating income and fair values of commercial real estate properties may fluctuate with economic cycles and as a result of other factors, so that debt service coverage may be unstable. The value of the property may not support the value of the loan if there is a default. 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.

Many commercial real estate loans are not fully amortizing and, therefore, the timely recovery of principal is dependent on the borrower's ability to refinance or sell the property at maturity.

7

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TABLE OF CONTENTS

The prices of commercial CES are more sensitive to adverse economic downturns or individual issuer developments than more highly rated real estate securities. A projection of an economic downturn, for example, could cause a decline in the price of commercial CES because of increasing concerns regarding the ability of obligors of loans underlying ABS to continue to make principal and interest payments.

For some types of loans in which we have had an economic interest in the past and may again in the future, the commercial real estate is in transition, such as a former office building that is in the process of being converted into condominiums. These loans entail higher risks than traditional commercial property loans made against stabilized properties. Initial debt service coverage ratios, loan-to-value ratios, and other indicators of credit quality for these loans may not meet standard market criteria for stabilized commercial real estate loans. The underlying properties may not transition or stabilize as expected. The personal guarantees and forms of cross-collateralization that are secured in connection with some of these loans may not be effective. In addition, we own some mezzanine loans that are not secured by a direct lien on the underlying property.

Our commercial loans are illiquid; if we choose to sell them, we may not be able to do so in a timely manner or for a satisfactory price. Financing these loans may be difficult, and may become more difficult if credit quality deteriorates.

Mezzanine loans, distressed assets, and loan participations have concentrated credit, servicing, and other risks. We have in the past directly originated some of our commercial loans and participated in the origination of others, and may do so again in the future. This may expose us to credit, legal, and other risks that may be greater than is usually present with acquired loans.

The nature of the assets underlying some of the securities we hold could increase the credit risk of those securities,

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. 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 special servicers. We review the underlying loan files prior to acquiring residential and commercial CES but our review may not uncover these or other issues at that time. By the time these problems become apparent, we may have little or no recourse to the issuer of the securities and we may incur losses as a result.

### **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 and securities. If unanticipated losses occur within the first few years after a loan is originated or a securitization is completed, those losses could have a greater negative impact on our investment returns than unanticipated losses on more mature loans or securities. In addition, higher levels of delinquencies and cumulative credit losses within a securitized loan pool can delay our receipt of the 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 new legislation or legal actions that allow for the modification of loans. It is difficult to anticipate what, if any, changes to underlying loans would be allowed and to determine the impact on these changes to ultimate credit losses or changes in interest income on our investments.

### **The securities and loans we own are likely to lead to variable returns.**

We actively manage the risks associated with acquiring, holding, and disposing of real estate loans and securities. No amount of risk management or mitigation, however, can change the variable nature of the cash flows, fair values of, and financial results generated by these loans and securities. Changes in the credit performance or the prepayments on these real estate loans and the loans underlying these securities and changes in interest rates impact the cash flows on these securities, and the impact could be significant for our securities with concentrated risks. Changes in cash flows lead to changes in our return and also to potential variability in reported income. The revenue recognized on most 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. We may be forced to recognize adverse changes

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## TABLE OF CONTENTS

in expected future cash flows as a current expense, further adding to earnings volatility. For other assets and some liabilities, our revenue and income is affected by changes in the fair value of our assets and liabilities, which may further accentuate our earnings volatility.

For other assets, our revenue and income, if any, are based on changes in the fair value of the asset. As market conditions, liquidity, perceptions, supply and demand, and the fundamentals of each asset change, the fair values can vary widely, causing volatility in our reported earnings. Fair values for illiquid assets can be difficult to ascertain accurately, which may also lead to volatility and uncertainty of earnings.

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

Fair values for our assets, liabilities, and hedges can be volatile. The fair values can change rapidly and significantly and changes can result from changes in interest rates, perceived risk, supply and demand, projected cash flows and prepayments and credit performance.

A decrease in fair value may not necessarily be the result of a deterioration in future cash flows. For GAAP purposes, we mark-to-market some, but not all, of our consolidated assets and liabilities through our consolidated balance sheet.

In addition, valuation adjustments on certain assets and many of our derivatives are reflected in our consolidated statement of income. As a result, assets that are funded with certain liabilities and interest-rate matched 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 basis, our reported earnings will be reduced.

A decrease in the fair value of the securities we own may result in a reduction in our book value due to the accounting standards we are required to apply, and could result in a negative book value. Reporting a low or negative book value could have adverse effects even if that the book value is not indicative of the actual value of our net investments in assets and securitization entities. The adverse effects include the inability to meet or agree upon covenants with counterparties or to enter into derivative contracts, and a reduction in the market price of our stock.

Effective January 1, 2008, we adopted a new accounting standard, Financial Accounting Standards Board Statement No. 159 *The Fair Value Option for Financial Assets and Financial* (FAS 159), which allows us to MTM both the consolidated assets and liabilities of Acacia. FAS 159 provides for a one-time cumulative-effect adjustment to retained earnings on the balance sheet on January 1, 2008 for the unrealized gains or losses on Acacia assets and liabilities at that time. We expect the adoption of FAS 159 will reduce the magnitude of the disparity that existed between the value of Acacia under GAAP presentation and the economic value of Acacia at December 31, 2007. Even following the adoption of FAS 159, however, there will likely be significant differences between the value of Acacia under GAAP presentation and the economic value of Acacia. Discrepancies arise as a result of market dynamics and the limitations of the measurement techniques required by FAS 159. In addition to affecting our GAAP balance sheet, the adoption of FAS 159 with respect to the Acacia assets and liabilities will also affect our income statements, as we will be required to record any net changes in the fair value those assets and liabilities in any given period. Fair values for illiquid assets can be difficult to ascertain accurately, which may lead to volatility and uncertainty of earnings. Moreover, on January 1, 2008, the fair values of the Acacia liabilities used for GAAP purposes were, in our view, depressed relative to the paired collateral asset values. If the fair values of these liabilities were to increase, these changes would appear on our GAAP income statements as negative MTM adjustments.

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

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 seek to hedge some but not all interest rate risks. Our hedging may not work effectively, or we may change our hedging strategies or the degree or type of interest rate risk we assume.

A portion of our equity-funded assets have adjustable-rate coupons. The cash flows we receive from these assets may vary as a function of interest rates, as do the GAAP earnings generated by these assets. We also

own debt-funded loans and securities which we hold as inventory prior to sale to a securitization entity or as a longer term investment. We fund these assets with equity and with floating rate debt. To the extent these assets have fixed or hybrid interest rates (or are adjustable with an adjustment period longer than our short-term debt), an interest rate mismatch exists and we will earn less (and fair values may decline) if interest rates rise. We usually, but not always, seek to mitigate interest rate mismatches for these assets with a hedging program using interest rate swaps and futures.

Interest rate changes have diverse and sometimes unpredictable effects on the prepayment rates of real estate loans. Changes in prepayment rates can lower the returns we earn from our assets, diminish or delay our cash flows, reduce the fair value of our assets, and decrease our liquidity.

Except with respect to our adjustable-rate assets, higher interest rates generally reduce the fair value of most of our assets. This may affect our earnings results, reduce our ability to 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, and possibly driving asset acquisition prices higher.

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 adjustable-rate residential whole loans.

If short-term interest rates fall, our premium amortization expense will increase on loans acquired by Sequoia prior to July 2004, which are reported on our consolidated balance sheet. Due to the GAAP principle applied to these adjustable-rate loans, the amortization expense for the current period is a function of actual and projected prepayments and the current LIBOR interest rate. During a period of rapidly falling rates, the effect that the interest rate has on the amortized amount becomes the more significant factor and will increase the amount amortized thereby decreasing our reported income for that period, all other factors being equal.

### **Credit ratings of debt securities may not accurately reflect the risks associated with those debt securities.**

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, the 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 initial credit ratings based on recently 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. We try to reduce the impact of the risk that a credit rating may not accurately reflect the risks associated with a particular debt security by not relying solely on credit ratings as the indicator of the quality of an investment. We make our acquisition decisions after factoring in other information. However, our assessment of the quality of an investment may also prove to be inaccurate and we may incur credit losses in excess of our initial expectations.

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 will have an impact on the amount securities that will be available to us either by the level of securitization and the various sizes of the investment-grade and non-investment-grade securities that are created in the future.

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

**Further 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.**

Some of the securities held by us through our Acacia entities as well some of the securities held by us at Redwood are insured by bond insurers such as Ambac Financial Group Inc., MBIA Inc, and Financial Guaranty Insurance Co., which are commonly known as the monoline insurers. These monoline insurers historically have had AAA credit ratings and this credit rating has been passed on to any bonds that they

10

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TABLE OF CONTENTS

insure. The high number of credit downgrades and other market events in the second half of 2007 revealed that these monoline insurers have greater credit risk exposure than previously realized and the credit ratings of a number of these insurers have been downgraded as a result. Any decline in the credit rating of a monoline insurer generally results in a corresponding decline in the credit ratings of the securities insured by that insurer.

Downgrades on securities could have an adverse effect on the value of some of our investments and our cash flows from those investments, particularly our equity investments in Acacia. The underlying documents of each Acacia securitization entity state that certain average rating levels must be met, and if not met on the securities held by the entity, then cash that would otherwise be distributed to the equity holders or the lower-rated debt holders, would instead be distributed to the more senior debt holders. Our investment in Acacia is primarily in the equity in the securitization entities, and the vast number of downgrades that rating agencies reported in late 2007 and early 2008 are likely to cause some of the Acacia entities to fail this average rating test, which will, in turn, adversely affect our cash flows on our investments in those entities.

Some of the loans held by our Sequoia securitization entities, or in which we have an indirect interest through securities we hold through Acacia or at Redwood, are insured in part by mortgage insurers. 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. Relatively few of the mortgages we hold through Sequoia are insured in this manner, as mortgage insurance generally is required 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), and the loan-to-value for most of the loans we hold through Sequoia are below this 80% threshold. Nonetheless, 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 those loans, which could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business.

**We have significant credit risk in California and may be disproportionately affected by an economic slowdown, natural disaster, or any other adverse event specific to California. We also have credit risk in other states and our business may be harmed by an economic slowdown, natural disaster, or any other adverse event in an area where do business.**

We have a concentration of residential and commercial real estate loans secured by property in California. In addition, a significant number of residential and commercial real estate loans that underlie the securities we own are secured by property in California. We have made efforts to mitigate the risks associated with geographic concentration. We have residential credit risk in all states and we do not have more than 1% of our residential loans in any one zip code. We

Further downgrades in the credit ratings of bond insurers or any downgrades in the credit ratings of mortgage insurers



also have commercial credit risk in most states. Nonetheless, we still have a significantly higher exposure in California and any event that adversely affected the California real estate market could have a disproportionately adverse effect on our business.

A decline in the economy or difficulties in the real estate markets 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 loans underlying our securities. This may then adversely affect our credit loss experience and other aspects of our business, including our ability to securitize real estate loans and securities.

The occurrence of a natural disaster (such as an earthquake, tornado, hurricane, or a flood) may cause a sudden decrease in the value of real estate and would likely reduce the value of the properties collateralizing the mortgage loans we own or those underlying the securities 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 on the pool of mortgage loans underlying the securities in which we provide credit-enhancement.

## **We assume credit risk on a variety of residential and commercial mortgage assets primarily through our investments in Acacia entities.**

The Acacia entities we sponsor own investment-grade and non-investment-grade securities (typically rated AAA through B, and in a second-loss position or better, or otherwise effectively more senior in the credit structure as compared to a first-loss residential CES or equivalent) issued by residential and commercial real

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### TABLE OF CONTENTS

estate loan securitization entities. Acacia also owns CDO securities created and issued by others and these securities usually have concentrated risks with respect to residential and commercial real estate. Acacia's securities are reported as part of our consolidated securities portfolio on our consolidated balance sheets. Generally, we do not control or influence the underwriting, servicing, management, or loss mitigation efforts with respect to the underlying assets in these securities. Some of the securities Acacia owns are backed by subprime loans and alt-a loans that have substantially higher risk characteristics than prime-quality loans. These lower-quality loans can be expected to have higher rates of delinquency and loss, and losses to Acacia (and thus Redwood as owner of the Acacia CDO equity securities) could occur. Some of the assets Acacia has acquired are investment-grade and non-investment-grade residential loan securities from the Sequoia securitization entities we have sponsored. Although we may have a limited degree of control or influence over the selection and management of the loans underlying Sequoia securitizations, we believe the possibility of loss on these assets remains approximately the same as it is for securities issued from securitizations of equivalent-quality loans that we did not sponsor. If the pools of residential loans underlying any of these securitizations were to experience poor credit results, Acacia's securities could have their credit ratings down-graded, could suffer declines in fair value, or could experience principal losses. If any of these events occurs, it would likely reduce our long-term returns and near-term cash flows from the Acacia CDO equity securities we have acquired, and may also reduce our ability to sponsor Acacia transactions in the future. We may securitize first-loss residential and commercial CES in Acacia in the future, which would add to the risks we undertake in our Acacia program.

## **Our efforts to manage credit risk may not be successful in limiting delinquencies and defaults in underlying loans or losses on our investments.**

Despite our efforts to manage credit risk, there are many aspects of credit risk that we cannot control. Our quality control and loss mitigation operations may not be successful in limiting future delinquencies, defaults, and losses. 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, bond insurance providers, and custodians, may not perform in a manner that promotes our interests.

The value of the homes collateralizing residential loans may decline. The value of the commercial properties collateralizing commercial loans 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, loans with balances over \$1 million, reduced documentation loans, subprime loans, alt-a loans, second lien loans, loans in certain locations, and loans that are partially collateralized by non-real estate assets may have increased risks and severity of loss. As loans become real estate owned, we bear the risk of not being able to sell the property and recovering our investment. Changes in consumer behavior, bankruptcy laws, tax laws, regulation on the mortgage industry, and other laws may exacerbate loan losses. Future changes in rules that would enable 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. The expansion of our loss mitigation efforts as we grow our portfolio will increase our operating costs and the expanded loss mitigation efforts may not reduce our future credit losses.

## **Our risk management efforts may not effectively mitigate the risks we seek to manage.**

We could incur substantial losses and our business operations could be disrupted if we are unable to effectively identify, manage, monitor, and mitigate operations risks, credit risks, interest rate risks, prepayment risks, liquidity risks, and other market risks related to our business, assets, and liabilities. We actively manage our risks but our risk management policies, procedures, and techniques may not be sufficient to mitigate the risks we have identified or to identify additional risks to which we are subject or may be subject in the future.

12

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### TABLE OF CONTENTS

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

Our loans and loans underlying securities are serviced by third-party service providers. These arrangements allow us to increase the volume of the loans we purchase and securitize without incurring the expenses associated with servicing operations. Should a servicer experience financial difficulties, it may not be able to perform these obligations. Servicers who have sought bankruptcy protection may, due to application of provisions of bankruptcy law, not be required to advance those amounts. Even if a servicer were able to advance amounts in respect of delinquent loans, its obligation to make the advances may be limited to the extent that it does not expect to recover the

Our efforts to manage credit risk may not be successful in limiting delinquencies and defaults in underlying loans or

advances due to the deteriorating credit of the delinquent loans. In addition, as with any external service provider, we are subject to the risks associated with inadequate or untimely services for other reasons. Servicers may not advance funds to us that would ordinarily be due because of errors, miscalculations or other reasons. Many borrowers require notices and reminders to keep their loans current and to prevent delinquencies and foreclosures, which our servicers may fail to provide. A substantial increase in our delinquency rate that results from improper servicing or loan performance in general may result in credit losses and could harm our ability to securitize our real estate loans in the future.

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

We have invested in and intend to continue invest in a variety of real estate and non-real estate related assets that may not be closely related to our current core business. Additionally, we may enter various securitization, service, and other operating businesses that may not be closely related to our current business. Any of these actions may expose us to new, different, or increased investment, operational, financial, or management risks. We have made investments in CDO debt and equity securities issued by CDO securitizations other than Acacia that own various types of assets, generally real estate related. These CDOs (as well as the Acacia entities) have invested in manufactured housing securities, subprime residential securities, and other residential securities backed by lower-quality borrowers. They also own a variety of commercial real estate loans and securities, corporate debt issued by REITs that own commercial real estate properties, and other assets that have diverse credit risks. We may invest in CDO equity securities issued by CDOs that own trust preferred securities issued by financial institutions or other types of non-real estate assets. We may invest directly or indirectly in real property. We may invest in non-real estate ABS or corporate debt or equity. We have invested in diverse types of IO securities 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.

### **New assets we acquire may not generate yields as attractive as yields on our current assets, resulting in a decline in our earnings per share over time.**

We believe the assets we acquire have the potential to generate attractive economic returns and GAAP yields, but acquiring assets in an uncertain economic environment poses risks. Potential cash flow and mark-to-market returns from new asset acquisitions could be negative, including both new assets that are backed by newly-originated loans, as well as new assets that are backed by more seasoned assets that may experience higher than expected levels of delinquency and default.

In order to maintain our portfolio size and our earnings, we reinvest in new earning assets a portion of the cash flows we receive from principal, interest, calls, and sales. We receive monthly payments from most of our assets, consisting of principal and interest. In addition, occasionally some of our residential loan CES are called (effectively sold). Principal payments and calls reduce the size of our current portfolio and generate cash for us. We also sell assets from time to time as part of our portfolio management and capital recycling strategies.

If the assets we acquire in the future earn lower GAAP yields than the assets we currently own, our reported earnings per share will likely decline over time as the older assets pay down, are called, or are sold. Under the effective yield method of accounting that we use for GAAP accounting purposes for some of our assets, we recognize yields on assets based on our assumptions regarding future cash flows. A portion of the

TABLE OF CONTENTS

cash flows we receive that exceeds the anticipated cash flows reduces our basis in these assets. As a result of these various factors, our basis for GAAP amortization purposes for many of our current assets is lower than their current fair values. Assets with a lower GAAP basis generate higher GAAP yields, yields that are not necessarily available on newly acquired assets. Business conditions, including credit results, prepayment patterns, and interest rate trends in the future are unlikely to be as favorable as they have been for the last few years.

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

To reinvest proceeds from principal repayments and deploy new capital that we may raise in the future, we must acquire new assets. If the availability of new assets is limited, we may not be able to acquire assets that will generate attractive returns. Generally, asset supply can be reduced if originations of a particular product are reduced, if there are few sales in the secondary market of seasoned product from existing portfolios, or if assets we believe have a favorable risk/reward ratio are not be available for purchase or if there is little or no demand for AAA-rated securities.

We do not originate loans and rely on the origination market to supply the types of loans we wish to credit-enhance. At times, due to heightened credit concerns, strengthened underwriting standards, or concerns about economic growth or housing values, the volume of originations may decrease significantly. In late 2007, the volume of subprime and alt-a loan originations was significantly lower than in recent years, and the volume may not return to previous levels in the foreseeable future. The future volume of prime loan originations may also be at a relatively low level. This reduced volume may make it difficult for us to compete and acquire loans.

The supply of new securitized assets available for purchase could be reduced if the economics or form of the securitization become unattractive. A key factor in the economics of securitization is a highly liquid market for AAA-rated securities. The events in late 2007 revealed that the liquidity of this market may be disrupted at times. Fears about credit quality and the changes in credit rating agencies analyses have dampened the demand for IGS backed by real estate loans and securities, and investor demand for these securities may not reach previous levels in the foreseeable future. Without a robust market for AAA-rated securities, the supply of real estate CES could be significantly diminished. In addition, the risks associated with the acquisition of loans for the purpose of securitization may increase significantly and we may choose not to acquire any loans during these periods.

**Our growth may be limited if we are not able to raise additional capital.**

As a REIT we are required to distribute at least 90% of our REIT taxable income. Thus, we do not generally have the ability to retain earnings and 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 secondary offerings. We may also raise capital by issuing other types of securities, such as preferred stock or convertible subordinated notes, or by taking on long-term debt.

We may not be able to raise capital at times when we see opportunities to employ capital. Many of the same factors that would make investments in real estate loans and securities attractive, such as the availability of assets from distressed owners who need to liquidate and thus may accept reduced prices, and uncertainty about credit risk, housing, and the economy, may make it difficult for us to convince new investors 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 a growth in our portfolios. Our plan is to grow and we build our infrastructure accordingly. If we are unable to raise capital and expand our portfolios, our operating expenses may increase significantly relative to our capital base.

## **Many of our investments have limited liquidity.**

The residential, commercial, and CDO CES we acquire are generally less liquid than the residential, commercial, and CDO IGS we acquire. In turbulent markets, it is likely that the liquidity of the lower-rated securities, and some of the higher-rated securities that we hold, may become even less liquid. As a result, we may not be able to sell certain assets at desirable times or at attractive prices and incur significant losses upon sale of the assets.

14

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### TABLE OF CONTENTS

As a result of the limited liquidity of the types of securities we acquire and our securitization entities issue, there may be little trading information available to verify the values at which we report these assets and liabilities on our financial statements. This makes the estimates of fair value reflected in our financial statements more speculative, and our reported earnings and book values may not reflect the values we ultimately realize from our portfolio.

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

We need cash to meet our interest expense payments, working capital, minimum REIT dividend distribution requirements, and other needs. We may also need cash to repay our recourse short-term borrowings in the event the fair values of our assets that serve as collateral for that debt decline, the terms of short-term debt become less attractive, or for other reasons.

Our sources of cash flow may not be sufficient to satisfy these needs. Cash flows from principal repayments could be reduced if prepayments slow or if credit quality deteriorates. Cashflows on our investments in CDOs (including investments in Acacia) may also be disrupted due to credit rating agencies downgrading securities owned by the securitization entity if certain average rating tests are not satisfied. 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. For some loans, borrowers have the option to make payments that are less than the fully amortized amount. Operating cash flows could be reduced if earnings are reduced, if discount amortization income significantly exceeds premium amortization expense, or for other reasons. Our minimum dividend distribution requirements could become large relative to our cash flows if our income as calculated for tax purposes significantly exceeds our net cash flows. This could occur due to taxable income (including amortization income and interest income on negative amortizing loans) exceeding cash flows received. 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.

## **We sometimes utilize financial leverage and this could expose us to increased risks.**

We have invested in IGS and residential whole loans that we have financed with various types of short-term debt. By incurring this leverage we can generate attractive returns on our equity invested in these assets. However, as a result of the leverage, we could incur significant losses if our borrowing costs increase relative to the earnings on our assets and hedges. These financing facilities may also force us to sell assets under adverse market conditions to meet the lenders margin calls in the event of a decrease in the fair values of the assets pledged as collateral. To the extent we do not have sufficient cash or other assets to post the margin calls, we could be forced to sell the assets. Liquidation of the collateral could create negative tax consequences and raise REIT qualification issues.

Although we typically seek a variety of financing facilities and counterparties, there can be no assurance that we will be able to renew those facilities when they mature. The failure to renew facilities could force us to sell assets in adverse market conditions. Liquidity in debt markets, including repo and commercial paper, can be withdrawn suddenly, making it difficult or expensive to renew short-term borrowings as they mature.

## **Changes in prepayment rates of residential real estate loans could reduce our earnings, dividends, cash flows, and access to liquidity.**

The economic returns we expect to earn from most of the residential real estate securities we or Acacia own and loans we or Sequoia own are affected by the rate of prepayment of the underlying residential real estate loans. Prepayments are unpredictable and adverse changes in the rate of prepayment could reduce our cash flows, earnings, and dividends.

Adverse changes in cash flows would likely reduce an asset's fair value, which could reduce our ability borrowed against that asset and may cause a market valuation adjustment 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 grow and generate earnings.

15

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### TABLE OF CONTENTS

We own a number of securities, the returns from which are strongly affected by 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.

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

We are subject to significant competition in seeking investments. Our competitors include other mortgage REITS, the Federal National Mortgage Association, referred to as Fannie Mae, the Federal Home Loan Mortgage Corporation, referred to as Freddie Mac, financial institutions, securities dealers, insurance companies, investment funds and other investors. In addition, other companies may be formed that will compete with us for investments or otherwise pursue investment strategies similar to ours. Some of our competitors have greater resources than us and we may not be able to compete successfully for investments. Furthermore, competition for investments may lead to a decrease in the returns available from the investments which may further limit our ability to generate desired returns.

Recent legislation may lead to increased competition. Until recently, Fannie Mae and Freddie Mac have been statutorily prohibited from purchasing loans in excess of \$417,000. On February 7, 2008, Congress passed an economic stimulus package that includes provisions that increase the size of the loans these entities may purchase to up to \$729,750 for loans originated between July 31, 2007, and December 31, 2008. Congress may decide to extend this window past December 31, 2008 or may otherwise increase the size of loans that these entities may acquire. Any such change would allow Fannie Mae and Freddie Mac to continue to compete against us in a market in which they had not been allowed to compete previously. The status of Fannie Mae and Freddie Mac as government-sponsored enterprises, combined with their size and other factors, make them significant competitors. If the size of the loans that Fannie Mae and Freddie Mac may acquire were to increase permanently, our business could be adversely affected.

## **Our securitization activities could expose us to litigation, which may adversely affect our business.**

We sponsor securitization entities which issue asset-backed securities. Through our Sequoia securitization entities, we issue ABS that are backed by mortgage loans held by the Sequoia entities. Through our Acacia securitization entities, we issue ABS that are backed by securities held by the Acacia entities. As a result of declining property values, increasing defaults and other factors, the cash flows from the loans held by the Sequoia entities and the securities held by the Acacia entities may be insufficient to repay in full the ABS issued. 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. Defending a lawsuit can consume significant resources and may divert management's attention from our ordinary operations.

## **Hedging activities may reduce long-term 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, to a lesser extent, prepayment risks) by balancing the characteristics of our assets 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 attempt to enter into interest rate hedges that provide an appropriate and efficient method for hedging the desired risk.

Hedging against interest rate risks using interest rate agreements and other instruments usually has the effect over time of lowering long-term earnings. To the extent that we hedge, it is usually to protect us from some of the effects of short-term interest rate volatility, to lower short-term earnings volatility, to stabilize liability costs or fair values, to stabilize our economic returns from or meet rating agency requirements with respect to a securitization, or to stabilize the future cost of anticipated ABS issuance by a securitization entity. Hedging may not achieve its desired goals.

Pipeline hedging for loan purchase commitments 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 to hedge the accounting treatment for our hedges (i.e., our hedges are accounted for as trading instruments). Reductions in fair values of interest rate

16

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### TABLE OF CONTENTS

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 collateral or cash.

We also may hedge by taking short, forward, or long positions in U.S. Treasuries, mortgage securities, or other cash instruments. We intend to 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 special liquidity, basis risks, and counterparty risks

Our quarterly earnings may be subject to fluctuations from period to period as a result of the accounting treatment for certain interest rate agreements or for assets or liabilities that do not necessarily match those used for interest rate agreements, or as a result of our failure to meet the requirements to obtain desired hedge accounting treatment for certain interest rate agreements.

## **We may invest in synthetic securities, including credit default swaps, which expose us to additional risks.**

We invest in synthetic securities including credit default swaps that reference other real estate securities. These investments may present risks in excess of those resulting from the referenced securities. An investment in a synthetic security is a contractual relationship with a counterparty and not an acquisition of the referenced security. In a synthetic investment, we have no right directly to enforce compliance with the terms of the referenced security, and we have no voting or other consensual rights of ownership with respect to the referenced security. 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.

The market for many synthetic securities, including credit default swaps referencing real estate securities, has only existed for a few years and is not liquid. Many of these credit default swaps incorporate pay as you go credit events which have been introduced into the market fairly recently. The terms of credit default swaps are still evolving and may change significantly which could make it more difficult to assign such an instrument or determine the loss pursuant to the underlying agreement. For example, in a credit default swap, the party wishing to buy protection will pay a premium. When interest rates change, the spreads change, or the prevailing credit premiums on credit default swaps change, the amount of the termination payment due could change by a substantial amount. In an illiquid market, the determination of this change could be difficult to ascertain and, as a result, we may not achieve the desired benefit of entering into this contractual relationship.

To date, we have entered into a limited number of synthetic securities agreements. We may over time increase our exposure to these investments as the market for them grows and during times when acquiring other real estate loans and securities may be difficult. We may find credit default swaps and other forms of synthetic securities to be a more efficient method of providing credit-enhancement on specific pools of real estate loans. We will attempt to manage the risks associated with these investments including counterparty risks, but our efforts may prove to be insufficient in enabling us to generate the returns anticipated.

## **We enter into derivative contracts that expose us to contingent liabilities and those contingent liabilities may not appear on our balance sheet.**

We enter into derivative contracts that could require us to make cash payments in certain circumstances. These potential payments 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.

## **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 the counterparty will fail to perform under its contractual arrangement with us. Counterparties may seek to eliminate credit exposure by entering into 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 segregations 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) limit our counterparty exposure to strong companies with investment-grade credit ratings; however, we are not always able to do so. Our counterparty risk management strategy may prove ineffective and, accordingly, our earnings could be adversely affected.

### **The expansion of our asset management business may expose us to new risks.**

We currently manage and receive a fee for managing the assets in Acacia. We anticipate expanding asset management initiatives in 2008 with the expected launch of Redwood Opportunity Fund, LP, and we may expand into more areas in the future. New asset management activities may increase our exposure to litigation, fiduciary responsibilities, conflicts of interest arising from Redwood's investment activities and the activities of the entities we manage, and other risks. We believe we can manage these risks effectively, but there can be no assurance that we will do so.

As we expand our asset management business, we will incur additional costs to establish new funds, limited partnerships, and other investment vehicles. Our efforts to raise capital for these ventures may not succeed, or the capital we raise may not be sufficient to offset the initial and ongoing costs of these ventures.

### **We may begin taking some foreign exchange risks.**

We are exploring the asset management business outside of the United States. To the extent we enter into commitments that will be paid with foreign currency, we will be exposed to foreign exchange risks. We may decide not to hedge or to otherwise manage this risk and the risk may become more significant over time.

### **Our securitization operations expose us to liquidity, fair value, and execution risks.**

In order to continue our residential loan and CDO securitization operations, we will require access to short-term debt to finance inventory accumulation prior to sale to the securitization entities. This debt may be unavailable or the terms of the available debt may be unfavorable to us. We expect to pledge the inventory assets we acquire to secure the short-term debt we incur. This debt will be recourse to us and if the fair value of the collateral declines, we will be required to increase the amount of collateral pledged to secure the debt or to reduce the debt amount. Our goal is to sell the assets acquired with the proceeds from the debt to a securitization entity; however, if our ability to complete the securitization is disrupted and we are unable to extend the term of the debt incurred to finance the acquisition of the assets, we may need to sell the assets (most likely at a loss).

When we acquire assets for a securitization, we make assumptions about the cash flows that will be generated from

the securitization of these assets. Widening ABS spreads, rising ABS yields, incorrect estimation of rating agency securitization requirements, poor hedging results, and other factors could result in a securitization execution that provides lower cash flows than initially assumed. This could result in a loss to us for tax purposes and reduced earnings for GAAP purposes.

Short-term borrowing arrangements used to support our securitization operations subject us to debt covenants. While these covenants have not meaningfully restricted our operations to date, as a practical

18

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## TABLE OF CONTENTS

matter, they could be restrictive or harmful to us in the future. In the event we violate debt covenants, we may incur expenses or losses, or our ability to incur additional debt may be restricted.

Our payment of commitment fees and other expenses to secure borrowing lines may not protect us from liquidity issues or losses. Variations in lenders' abilities to access funds, lender confidence in us, lender collateral requirements, available borrowing rates, the acceptability and fair values of our collateral, and other factors could force us to utilize our liquidity reserves or to sell assets to fund the purchase of assets for sale to securitization entities, thus affecting our liquidity, financial soundness, and earnings.

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

We depend upon the issuance of mortgage backed securities by the securitization entities we sponsor as a funding source for our business. The credit rating agencies determine the amount of net investment we must make in the securitization entities to credit-enhance the securities issued by those entities. Increases in the amount of the net investment the credit agencies requires us to make could adversely affect our ability to sponsor new securitization entities. In addition, if the market for securitizations should become disrupted, the securitization entities we sponsor may be unable to issue ABS. In this event, our ability to continue to acquire loans and securities would be impaired and our earnings and ability to grow may be adversely affected.

### **We have exposure under representations and warranties we make in the contracts of sale of loans to securitization entities.**

In connection with our securitization activities, we sell the loans to the securitization entities we sponsor pursuant to agreements in which we make representations and warranties to those securitization entities with respect to the assets we transfer to them. If it turns out that because of irregularities in the underlying loans, our representations and warranties are inaccurate, we may be obligated to repurchase the loans from the securitization entities at principal value, which may exceed market value. We generally obtain representations and warranties that parallel those we provide to the securitization entities from the parties from whom we acquired the loans. As a result, we believe that we should, in most circumstances, be able to compel the original sellers of the loans to repurchase from us the loans we are obligated to repurchase from the securitization entities. However, if the representations and warranties are not parallel, or if the original seller is not in a financial position to be able to repurchase the loans, we may incur a loss upon repurchase of the loans from the securitization entity.

**If we fail to develop, enhance, and implement strategies to adapt to changing conditions in the mortgage industry and capital markets, our financial condition and earnings may be adversely affected.**

The manner in which we compete and the products for which we compete are affected by changing conditions which can take the form of trends or sudden changes in our industry, regulatory environment, changes in the role of government sponsored entities, credit rating agencies changes in their role or rating criteria or process, or 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 financial condition and earnings may be adversely affected.

**Our reported GAAP financial results differ from the taxable income results that drive our dividend distributions and reliance on GAAP results may not accurately reflect future taxable income and dividend distributions.**

We manage our business based on long-term opportunities to generate cash flows. Our dividend distributions are driven by our minimum dividend distribution requirements under the REIT tax laws and our taxable income as calculated for tax purposes pursuant to the Internal Revenue Code. Our reported results for GAAP purposes may differ materially, however, from both the cash flows and our taxable income.

In determining our REIT taxable income (which drives our minimum dividend distribution requirements as a REIT), no current tax deduction is available for future credit losses that are anticipated to occur. Credit losses can only be deducted for tax purposes when they are actually realized. As a result, for tax purposes, there is no credit reserve or reduction of yield accruals based on anticipated losses, and an increase in our credit losses in the future will reduce our taxable income (and dividend distribution requirements). By

19

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TABLE OF CONTENTS

contrast, for GAAP purposes, we are required to reflect in our results of operations assumptions about the amount and timing of credit losses in advance of when the losses are actually realized. As a result, the occurrence of these assumed losses will not directly impact our future GAAP income (although they could lead to additional provisions or credit reserve designations to provide for potential additional losses in the event we revise our assumptions).

For tax purposes, we do not mark-to-market any asset or liability. Any potential gain, loss, or impairment on an asset or liability is generally recognized for taxable income purposes only at the time of sale, call, or maturity of the asset or liability. For GAAP accounting purposes, certain assets and liabilities are marked-to-market with the changes in the fair values being reflected in the income statement in some cases. Thus, the amount and timing of any changes in the fair value of an asset or liability will likely be reported on substantially different bases when calculating GAAP and taxable income.

Accounting for compensation expense also varies for GAAP and tax calculations, especially in how equity awards (such as options and deferred stock units) are determined. For the most part, under GAAP, the total expense associated with an award is determined at the award date and is recognized over the vesting period. For tax purposes, the expense is recognized at the date of distribution or exercise. This leads to the potential that the total expense related to equity awards, as well as the timing for the recognition of the expense, could be significantly different for GAAP and tax purposes.

If we fail to develop, enhance, and implement strategies to adapt to changing conditions in the mortgage industry and

There are other differences in calculating taxable and GAAP income and there could be further differences as accounting principles and tax regulations change.

As a result of these differences in GAAP and tax accounting, our cumulative taxable income and our cumulative dividend distributions have been far greater than our cumulative reported GAAP income. To the extent that the credit loss assumptions we use for GAAP purposes on our existing portfolio do occur, then we would expect our future taxable income to decrease as the credit losses occur. To the extent the other-than-temporary impairments we have recognized for GAAP purposes reflect a decrease in future cash flows, then our taxable income will decrease. Our GAAP income to date includes the expense of vested equity awards that have not yet been distributed or exercised. The taxable expense we will incur on these equity awards will be dependent on the value of our common stock at future dates and this amount could be significant in any one period depending on the timing of distributions and exercises.

Taxable income consists of ordinary income and capital gains and losses. In order to recognize capital losses, we can only offset them against capital gains. There can be no assurance that we could generate capital gains to offset any capital losses we incur. Thus, in such instances, our dividend distributions would not be reduced even by the amounts of any unused capital losses.

**Our reported income depends on estimates and assumptions about the future and actual results may vary from our estimates, resulting in fluctuations in our balance sheet and earnings.**

The preparation of financial statements in conformity with GAAP requires us to make a significant number of estimates. These estimates include the fair value of certain assets and liabilities, the amount and timing of credit losses, prepayment rates, and other items that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses recognized during the reported period. Our estimates are inherently subjective in nature and fluctuations in our reported earnings will result when actual results differ from our estimates.

**To prepare our financial statements we depend on accounting principles, conventions, and interpretations to prepare our financial statements. Over time, accounting principles, conventions, and interpretations may change, which could affect our reported income, 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.

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TABLE OF CONTENTS

**We may change our policies, procedures, practices, product lines, leverage, risks, hedging strategies, or internal risk-adjusted capital guidelines in ways that may increase our risk exposure.**

We may alter our policies, procedures, practices, product lines, leverage, risks, internal risk-adjusted capital guidelines, and other aspects of our business. We may enter into new businesses, relationships, or partnerships or pursue acquisitions of other companies or a variety of different types of assets. These changes may increase the

Our reported GAAP financial results differ from the taxable income results that drive our dividend distributions and re

magnitude of the risks to which we are exposed.

### **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. Experienced personnel are in high demand and competition for their talents is intense. There can be no assurance that we will continue to attract and retain key personnel.

### **Our technology infrastructure and systems are important and any significant disruption could have an adverse effect on our business.**

In order to analyze, acquire, and manage our securities and manage the risks associated with our business, assets, and liabilities, we rely upon computer hardware and software systems. Some of these systems are located at our office and some are maintained by third party vendors. Any significant interruption in the availability or functionality of these systems could have an adverse effect on our business.

We have taken steps to provide for the security of our systems and data. However, these security measures may not effectively prevent others from obtaining improper access to our systems data. Improper access could expose us to risks of data loss, litigation, and liabilities to third parties, and otherwise disrupt our operations.

### **Our business could be adversely affected if we have deficiencies in our disclosure controls and procedures or internal control over financial reporting.**

The design and effectiveness of our disclosure controls and procedures and internal control 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 control over financial reporting, there can be no assurance that our disclosure controls and procedures or internal control over financial reporting will be effective in accomplishing all control objectives all of the time. Deficiencies, particularly material weaknesses, in internal control over financial reporting which may occur in the future could result in misstatements of our results of operations, restatements of our financial statements, a decline in our stock price, or otherwise materially and adversely affect our business, reputation, results of operation, financial condition, or liquidity.

## **Risks Related to our Company Structure**

### **Failure to qualify as a REIT would adversely affect our dividend distributions and could adversely affect the value of our securities.**

We believe that we have met all requirements for qualification as a REIT for federal income tax purposes for all tax years since 1994 and we intend to continue to operate so as to qualify as a REIT in the future. 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, no assurance can be given that the Internal Revenue Service or a court would agree with our conclusion that we have qualified as a REIT or that future changes in our factual situation or the law will allow us to remain qualified as a REIT. 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. Failure to qualify as a REIT would adversely affect our dividend distributions and could adversely affect the value of our common stock.

We may change our policies, procedures, practices, product lines, leverage, risks, hedging strategies, or internal risk

## **Maintaining REIT status may reduce our flexibility.**

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:

21

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### TABLE OF CONTENTS

If we make frequent asset sales from our REIT entities to persons deemed customers, we could be viewed as a dealer, and thus subject to 100% prohibited transaction taxes or other entity-level taxes on income from such transactions.

Compliance with the REIT income and asset rules may limit the type or extent of hedging that we can undertake. Our ability to own non-real estate related assets and earn non-real estate related income is limited. Our ability to own equity interests in other entities is limited. If we fail to comply with these limits, we may be forced to liquidate attractive assets on short notice on unfavorable terms in order to maintain our REIT status.

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 taxable REIT affiliates in the future.

Meeting minimum REIT dividend distribution requirements could reduce our liquidity. Earning non-cash REIT taxable income could necessitate our selling assets, incurring debt, or raising new equity in order to fund dividend distributions.

Stock ownership tests may limit our ability to raise significant amounts of equity capital from one source.

In addition, historically, our stated goal has been to not generate excess inclusion income that would be taxable as unrelated business taxable income (UBTI) to our tax-exempt stockholders. Achieving this goal has limited our flexibility in pursuing certain transactions and may continue to do so in the future. Despite our efforts to do so, we may not be able to avoid creating or distributing UBTI to our stockholders.

## **Changes in tax rules could adversely affect REITs.**

The requirements for maintaining REIT status or the taxation of REITs could change in a manner adverse to our operations. Rules regarding the taxation of dividends are enacted from time to time and future legislative or regulatory changes may limit the tax benefits accorded to REITs, either of which may reduce some of a REIT's competitive edge relative to non-REIT corporations.

## **We may create new entities that are initially entirely owned by Redwood for specific purposes and those entities may be taxable REIT subsidiaries and increase our costs of operations.**

In order to expand our business, seek new opportunities, or for other business reasons, we may create new subsidiaries. Generally, these would be wholly-owned by Redwood. The creation of those subsidiaries may increase our administrative costs and expose us to other legal and reporting obligations. Some of these entities may be incorporated in states other than Maryland and some may be set up to expand into international businesses.

Some of these entities will be taxable REIT subsidiaries. Taxable REIT subsidiaries are wholly-owned subsidiaries of a REIT that pay corporate income tax on the income generated. That is, a taxable REIT 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. Thus, we expect that income generated by our taxable REIT subsidiaries will be subject to corporate income taxes and we will retain the income at that entity.

## **Failure to continue to qualify for the Investment Company Act exclusion could harm us.**

Under the Investment Company Act of 1940, as amended, 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, companies primarily engaged in the business of acquiring mortgages and other liens on and interests in real estate (i.e., qualifying interests) are excluded from the requirements of the Investment Company Act. To qualify for the Investment Company Act exclusion, we, among other things, must maintain at least 55% of our assets in certain qualifying real estate assets (the 55% Requirement) and are also required to maintain an additional 25% in qualifying assets or other real estate-related assets (the 25% Requirement).

22

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### TABLE OF CONTENTS

If we failed to meet the 55% Requirement and 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 harm us. Further, if we were deemed an unregistered investment company, we could be subject to monetary penalties and injunctive relief. We may 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 of 1940, as amended.

## **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 stockholders.**

In order to maintain our qualifications 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 risk of losing our status as a REIT due to concentration of ownership among our stockholders, our charter generally prohibits any single stockholder, or any group of affiliated stockholders, 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. As of December 31, 2007, our board of directors has granted waivers to two parties to own shares in excess of 9.8%, each subject to terms and conditions including the execution of a voting agreement. These voting agreements apply to the shares owned in excess of 9.8% by each party and states that they shall be voted on matters in the same proportion as all other shares are voted (exclusive of the 9.8% block voted by the interested party.)

Certain other provisions contained in our charter and bylaws and in the Maryland General Corporation Law (MCGL) may have the effect of discouraging a third-party from making an acquisition proposal for us and may therefore inhibit a change in control. 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 stockholders. In addition, provisions in our charter and the MCGL restrict our stockholders' ability to remove directors and fill vacancies on our board of directors and restrict unsolicited share acquisitions. Our charter provides that our board of directors is divided into three classes serving staggered terms of office of three years each, and thus at least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a

majority of our directors. These provisions may deter offers to acquire our stock or large blocks of our stock upon terms attractive to our stockholders, thereby limiting the opportunity for stockholders to receive a premium for their shares over then-prevailing market prices.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

Redwood has two leases for executive and administrative offices at One Belvedere Place, Mill Valley, California 94941. One lease expires in 2013 and the second lease expires in 2018. The 2008 rent obligation for these leases is approximately \$1.6 million.

## ITEM 3. LEGAL PROCEEDINGS

At December 31, 2007, to our knowledge there were no legal proceedings to which we were a party or to which any of our properties was subject.

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of Redwood's stockholders during the fourth quarter of 2007.

23

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### TABLE OF CONTENTS

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Redwood's common stock is listed and traded on the NYSE under the symbol RWT. As of March 4, 2008, Redwood's common stock was held by approximately 2,000 holders of record and the total number of beneficial stockholders holding stock through depository companies was approximately 30,000. As of March 4, 2008, there were 32,608,498 shares outstanding. The high and low sales prices of shares of the common stock as reported on the NYSE and the cash dividends declared on Redwood's common stock for the periods indicated below were as follows:

Stock Prices		Common Dividends Declared			
High	Low	Record Date	Payable Date	Per Share	Dividend Type

Year Ended December 31, 2007



Fourth Quarter	\$37.25	\$25.00	12/31/2007	1/22/2008	\$0.75	Regular
			12/26/2007	12/7/2007	\$2.00	Special
Third Quarter	\$49.57	\$28.80	9/28/2007	10/22/2007	\$0.75	Regular
Second Quarter	\$54.24	\$47.68	6/29/2007	7/23/2007	\$0.75	Regular
First Quarter	\$66.00	\$50.19	3/30/2007	4/23/2007	\$0.75	Regular
Year Ended December 31, 2006						
Fourth Quarter	\$59.75	\$50.23	12/29/2006	1/22/2007	\$0.70	Regular
			11/27/2006	12/8/2006	\$3.00	Special
Third Quarter	\$51.82	\$47.07	9/29/2006	10/23/2006	\$0.70	Regular
Second Quarter	\$48.83	\$40.36	6/30/2006	7/21/2006	\$0.70	Regular
First Quarter	\$44.85	\$40.98	3/31/2006	4/21/2006	\$0.70	Regular

We intend to distribute to our stockholders at least 90% of our REIT taxable income. All dividend distributions are made with the authorization of the board of directors at its discretion and will depend on our REIT taxable earnings, financial condition, maintenance of REIT status, and such other factors as the board of directors may deem relevant from time to time.

We announced a new 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. There were no repurchases during 2007, and as of December 31, 2007, there remained 5,000,000 shares available for repurchase under this plan.

24

TABLE OF CONTENTS

## Performance Graph

The following graph presents a 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. 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.

## Five Year Total Return Comparison December 31, 2002 through December 31, 2007

	2002	2003	2004	2005	2006	2007
Redwood Trust, Inc	100.00	213.45	300.72	226.42	355.32	239.87
S&P Composite-500 Index	100.00	128.70	142.70	149.71	173.35	182.88
NAREIT Mortgage REIT Index	100.00	157.39	186.40	143.18	170.85	98.50

25

TABLE OF CONTENTS

## ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data for 2007, 2006, 2005, 2004, and 2003 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. Certain amounts for prior periods have been reclassified to conform to the 2007 presentation.

(In Thousands, Except Per Share Data)	2007	2006	2005	2004	2003
Selected Statement of Operations Data:					
Interest income	\$855,540	\$885,160	\$962,197	\$651,618	\$330,976
Interest expense	(651,762 )	(701,704 )	(757,270 )	(431,421 )	(202,861 )
Net interest income	203,778	183,456	204,927	220,197	128,115
Operating expenses	(58,555 )	(55,925 )	(48,382 )	(38,692 )	(36,895 )
Realized gains on sales and calls, net	12,781	22,557	65,879	66,378	53,531
Market valuation adjustments, net	(1,261,449 )	(12,586 )	(5,031 )	(7,251 )	(6,855 )
Provision for income taxes	(5,192 )	(9,970 )	(17,521 )	(7,997 )	(5,502 )
Dividends on Class B preferred stock					(681 )
Undistributed earnings allocated to Class B preferred stock					(15 )
Net (loss) income available to common stockholders	\$(1,108,637 )	\$127,532	\$199,872	\$232,635	\$131,698
Average common shares basic	27,928,234	25,718,435	24,637,016	21,437,253	17,759,346
Net (loss) income per share basic	\$(39.70 )	\$4.96	\$8.11	\$10.85	\$7.42
Average common shares diluted	27,928,234	26,313,826	25,121,467	22,228,929	18,812,166
Net (loss) income per share diluted	\$(39.70 )	\$4.85	\$7.96	\$10.47	\$7.04
Dividends declared per Class B preferred share					\$0.76
Regular dividends declared per common share	\$3.00	\$2.80	\$2.80	\$2.68	\$2.60
Special dividends declared per common share	\$2.00	\$3.00	\$3.00	\$6.00	\$4.75
Total dividends declared per common share	\$5.00	\$5.80	\$5.80	\$8.68	\$7.35
Selected Balance Sheet Data:					
Earning assets	\$9,695,240	\$12,752,890	\$16,529,286	\$24,572,723	\$17,543,487
Total assets	\$9,938,472	\$13,030,473	\$16,776,960	\$24,778,065	\$17,670,386
Redwood debt	\$7,561	\$1,856,208	\$169,707	\$203,281	\$236,437
Asset-backed securities issued	\$10,329,279	\$9,979,224	\$15,585,277	\$23,630,162	\$16,826,202
Subordinated notes	\$150,000	\$100,000			
Total liabilities	\$10,656,751	\$12,027,783	\$15,842,000	\$23,913,909	\$17,117,058
Total stockholders (deficit) equity	\$(718,279 )	\$1,002,690	\$934,960	\$864,156	\$553,328
Number of common shares outstanding	32,385,073	26,733,460	25,132,625	24,153,576	19,062,983

Book value per common share	\$(22.18 )	\$37.51	\$37.20	\$35.78	\$29.03
Other Selected Data:					
Average assets	\$12,177,451	\$14,123,151	\$21,797,922	\$21,559,604	\$11,058,272
Average debt and ABS issued outstanding	\$11,322,898	\$12,996,244	\$20,710,057	\$20,748,658	\$10,489,614
Average common equity	\$723,807	\$988,495	\$970,269	\$730,499	\$526,808
Net income/average common equity	(153.2 )%	12.9 %	20.6 %	31.8 %	25.3 %

26

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TABLE OF CONTENTS

## ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Summary

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), is a financial institution focused on investing in, financing, and managing residential and commercial real estate loans and securities. We seek to invest in assets that have the potential to provide high cash flow returns over a long period of time to help support our goal of distributing attractive levels of dividends per share. For tax purposes, we are structured as a real estate investment trust (REIT).

Our primary source of income is net interest income, which equals the interest income we earn from our investments in loans and securities less the interest expenses we incur from our borrowed funds and other liabilities. We assume a range of risks in our investments and the level of assumed risk dictates the manner in which we finance our purchase of and derive income from these investments.

Our investments in residential, commercial, and collateralized debt obligation (CDO) credit-enhancement securities (CES, or below investment-grade securities) have concentrated credit risk. We finance the acquisition of most of our first-loss and equivalent CES that are directly exposed to credit losses with capital. To date, our primary credit-enhancement investment focus has been in securities backed by high-quality residential and commercial real estate loans. High-quality real estate loans are loans that typically have low loan-to-value ratios, borrowers with strong credit histories, and other indications of quality relative to the range of loans within U.S. real estate markets as a whole. Our CES investment returns depend on the amount and timing of the interest and principal collected on the loans in the pools supporting the securities. In an ideal environment, for most of our residential CES, we would experience fast loan prepayments and low credit losses which would, in turn, lead to attractive CES returns. Conversely, the return on most of our residential CES investments would be adversely affected by slow loan prepayments and high credit losses.

We also make investments in the securitization entities we sponsor Sequoia and Acacia. The Sequoia entities hold real estate loans. The Acacia entities generally hold investment-grade securities (IGS), which have less concentrated credit risk than CES, as well as some second-loss, third-loss, and equivalent securities. The income we earn on our investment in the equity of these securitization entities is based upon the spread between the yield on the assets owned by each entity and the cost of funds borrowed to fund those assets. The cost of funds is the interest paid on the asset-backed securities (ABS) issued by each of these entities. Each entity is independent of Redwood and of each other and the assets and obligations are not owned by and are not obligations of Redwood.

During 2007, the most significant factor affecting our consolidated financial statements was the extensive price decline in real estate securities that began early in the year and continued unabated through the end of the fourth quarter. This price decline caused a substantial decline in our reported GAAP book value and earnings. We believe the real economic impact on Redwood is significantly less severe than the financial reporting impact reflected in our consolidated financial statements for the year ended December 31, 2007. The primary reason for the divergence between economics and GAAP relates to the accounting treatment required for our investments in the Acacia securitization entities.

For accounting purposes, we consolidate the balance sheets and income statements of the Acacia securitization entities. In 2007, we were required, for financial statement purposes, to mark-to-market (MTM) all of the assets of Acacia to fair value, but we were not permitted to MTM paired liabilities. The GAAP accounting treatment resulted in a carrying value for our investments in Acacia of a negative \$1.4 billion at December 31, 2007. On January 1, 2008, we elected to adopt a new accounting standard, SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159), to value the assets and liabilities of the Acacia entities. This new standard significantly improved the disparity that existed between the GAAP carrying value of our Acacia investments and our estimate of the economic value of those investments. In accordance with FAS 159, we recorded a one-time, cumulative-effect adjustment to our balance sheet that increased the balance of our stockholders' equity at January 1, 2008 by \$1.5 billion. Our reported consolidated stockholders' equity at December 31, 2007 was a negative \$718 million. After giving effect to the adoption of FAS 159, our reported GAAP stockholders' equity at January 1, 2008 was a positive \$751 million.

27

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## TABLE OF CONTENTS

### Results

In 2007, our reported GAAP net loss was \$1.1 billion (\$39.70 per share) compared to GAAP net income of \$128 million (\$4.85 per share) in 2006. We paid \$5.00 per share in dividends in 2007 (consisting of \$3.00 per share in regular dividends and a \$2.00 per share special dividend). Our board of directors has announced its intention to maintain the regular dividend at \$0.75 per share per quarter in 2008.

### Table 1 Net Income

(In Thousands, Except Share Data)	2007	2006	2005
Total interest income	\$855,540	\$885,160	\$962,197
Total interest expense	(651,762 )	(701,704 )	(757,270 )
Net interest income	203,778	183,456	204,927
Operating expenses	(58,555 )	(55,925 )	(48,382 )
Realized gains on sales and calls, net	12,781	22,557	65,879
Market valuation adjustments, net	(1,261,449 )	(12,586 )	(5,031 )
Provision for income taxes	(5,192 )	(9,970 )	(17,521 )
Net (Loss) Income	\$(1,108,637 )	\$127,532	\$199,872
Diluted common shares	27,928,234	26,313,826	25,121,467
Net (loss) income per share	\$(39.70 )	\$4.85	\$7.96

By far the largest factor in the decline in net income in 2007 was a \$1.3 billion increase in negative mark-to-market valuation adjustments. Another factor negatively affecting our net income relative to the prior year was a \$10 million decline in gains generated from sales and calls of assets. Operating expenses increased from \$56 million in 2006 to \$59 million in 2007 as a result an increase in headcount and a reorganization of our residential and commercial

operations, partially offset by a decrease in bonus awards as a result of the company's GAAP results.

On the positive side, our operating results in 2007 were strong. Net interest income increased to \$204 million in 2007, up from \$184 million in 2006. This increase in net interest income was attributable to higher net interest income from our CES and IGS partially offset by a decline in the aggregate net interest income from our Sequoia investments caused by a reduction in the volume of loans held by the Sequoia entities in 2007 relative to 2006. Provision for income taxes decreased from \$10 million in 2006 to \$5 million in 2007.

Our estimated taxable income in 2007 was \$5.79 per share, as compared to \$6.75 per share in 2006, and our REIT taxable income in 2007 was \$5.65 per share, as compared with \$6.45 per share in 2006. Our REIT taxable income determines the minimum amount of dividends we must distribute in order to maintain our tax status as a REIT.

Taxable income continues to run higher than GAAP income as we are not permitted to establish credit reserves or recognize MTM adjustments (impairments) for tax purposes. We amortize more of our CES discount into income for tax purposes, generally do not record impairments for tax purposes, and have a higher tax basis in these securities. Consequently, any future credit losses on our CES will have a more significant impact on taxable income and REIT taxable income compared to GAAP income. See Potential Income Tax Volatility later in this document.

The non-GAAP pro forma consolidating income statement shown below highlights the significant impact from the consolidation of Acacia securitization entities on our overall results. For the reasons described in the Mark-to-Market Adjustments Discussion below, we believe the net economic loss from our Acacia investments was significantly less than the net loss of \$1.0 billion reported under GAAP.

28

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TABLE OF CONTENTS

**Table 2 Non-GAAP Pro Forma Consolidating Income Statements**

(In Millions)	Year Ended December 31, 2007			
	Redwood Parent Only	Sequoia	Acacia	Redwood Consolidated
Net interest income	\$ 133	\$ 29	\$ 42	\$ 204
Operating expenses	(59 )			(59 )
Realized gains on sales and calls, net	15		(2 )	13
Market valuation adjustments, net	(174 )		(1,087 )	(1,261 )
Net (loss) income before provision for income taxes	(85 )	29	(1,047 )	(1,103 )
Provision for income taxes	(5 )			(5 )
Net (Loss) Income	\$ (90 )	\$ 29	\$ (1,047 )	\$ (1,108 )

*This is a non-GAAP presentation. In a GAAP presentation, the Redwood income column shown above would reflect the income from Sequoia and the loss from Acacia.*

It is likely that we will continue to experience earnings volatility as a result of MTM adjustments in 2008. In particular, prices for real estate securities have continued to decline in the first quarter of 2008. We may also encounter further MTM adjustments from impairments on CES held at Redwood and from the consolidation of Acacia entities even after the adoption of FAS 159. These items are discussed in detail in the Mark-to-Market Adjustments Discussion that follows.

We believe that it is highly likely that the net interest income contribution from our existing Acacia investments will be lower in 2008 in comparison to 2007. Cash distributions from our Acacia investments can be disrupted based on credit rating agencies' downgrades of the underlying collateral or due to deterioration in collateral performance. Our investment in each of these entities is separate and independent, thus diminished performance for one of our investments would have no effect on our investments in the other Acacia entities. We believe there is a strong likelihood that cash flows from our investments in four of the Acacia entities could be disrupted in the first or second quarter of 2008 and the cash flows from our investment in a fifth Acacia entity could be disrupted within a year. During the year ended December 31, 2007, the net interest income reported from our investments in these five entities was \$21 million of the \$42 million total net interest income shown in the table above.

## Market Conditions and Activity

A broad re-evaluation of residential and commercial mortgage credit risk and the subsequent reduction in market values began early in the year and continued unabated through the end of the fourth quarter of 2007 and into the first quarter of 2008. The most dramatic negative price adjustments involved residential mortgage-backed securities (RMBS) and CDO securities backed by subprime and alt-a mortgages originated in 2006 and 2007.

29

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### TABLE OF CONTENTS

The table below illustrates the additional interest rate spread that investors have required to compensate for the perceived additional credit risk of various types of RMBS and commercial mortgage-backed securities (CMBS).

We believe several converging factors led to the broad decline in capital markets pricing for RMBS, CMBS, and CDO securities which, in turn, negatively affected our operating results and caused us to incur dramatic negative mark-to-market valuation adjustments against our securities portfolio. These factors included:

- declines in residential and commercial real estate prices;
- a rapid increase in the number of delinquent residential mortgage loans;
- a reduced willingness of investors to acquire commercial paper or other short-term debt backed by mortgage collateral;
- credit-rating downgrades by credit rating agencies of numerous mortgage-backed securities and of bond insurers;
- overall contraction in market liquidity;
- forced selling, caused by margin calls and other factors;
- the impact of speculation in related derivatives markets; and
- a general unwillingness of investors to acquire assets in a falling market.

In addition, market trading activity during the second half of 2007 was unusually light. We believe that uncertainty related to future loss estimates made it difficult for willing buyers and sellers to agree on price. Correspondingly, new securitization activity was low throughout the second half of 2007 and remained at low levels into the first quarter of 2008. These changing market conditions have impacted our activities and operations in a variety of ways, while our core focus has remained consistent. Over the past few years, we have focused on establishing a foundation for growth. We have laid this foundation by diversifying our investment and financing capabilities, strengthening the Redwood team, and bolstering our systems and infrastructure. These remain top priorities for us going forward. At the same time, however, the manner in which we utilize these resources has evolved, and will continue to do so, in response to changing market conditions.

During the first half of 2007, when market conditions began to show signs of a correction, we closely monitored our acquisition decisions while continuing to acquire real estate securities, both as investments and for planned Acacia

CDO entities, as well as loans for planned Sequoia entities. As market conditions became more turbulent toward the end of the second quarter and through the third quarter, we reduced our acquisition activity, focusing instead on strengthening our liquidity position and freeing up capital for deployment into higher yielding assets. During the fourth quarter, while continuing to focus on maintaining the strength of our capital base, we began to take advantage of some of the acquisition opportunities created by the current market conditions.

30

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## TABLE OF CONTENTS

The majority of our residential CES was originated during or prior to 2005, and these securities continue to perform in line with or better than our original expectations. The prime and alt-a loans backing these seasoned CES have generally exhibited strong payment histories and declining loan-to-value ratios due to principal pay-downs and home price appreciation in the earlier years of those loans. In contrast, our residential CES originated in 2006 and 2007 are performing below our original expectations. We have assessed our exposure to these vintages (\$48 million or 30% of total residential CES) and believe we were adequately reserved for credit losses at December 31, 2007.

Our commercial CES portfolio continues to perform well in the face of weakening fundamentals for this asset class in general. Serious delinquencies on commercial loans underlying CES are still near industry historic lows. We expect industry default rates to increase and approach 1% during 2008. As expected with diverse CMBS collateral pools, we continue to experience isolated defaults that have not been indicative of overall performance trends to date. We believe that our credit reserves adequately provided for expected losses on all of our credit-sensitive commercial securities at December 31, 2007.

We expect that an economic stimulus package recently passed by Congress, which raises conforming limits for Freddie Mac and Fannie Mae eligible loans, will have a modest positive impact on our credit-enhancement portfolio. The long-term impact, however, remains unclear.

## **Capital and Liquidity**

Our excess capital position was \$282 million at December 31, 2007, an increase from the \$183 million we had at the end of 2006. Our sources of capital during the year were \$185 million from stock issuance, \$50 million from the issuance of subordinated notes, \$216 million from portfolio cash flows in excess of our operating costs, and \$276 million from asset sales to third parties and our securitization entities. During the year, we used \$485 million of capital for new investments and \$143 million of capital for dividend payments.

Our year-end liquidity position remained strong at \$297 million. Redwood debt (short-term debt not included in capital) was \$8 million at the end of the year. We continue to have no liquidity issues or need to sell assets and, using our excess capital, have commenced investing in new long-term assets.

Although we intend to be cautious in deploying our capital in 2008, we believe there may be extraordinary opportunities in 2008 to make new investments with long-term earnings potential at attractive prices. Price levels for many real estate assets are now at historic lows, providing a substantial cushion against future losses. We have begun to see compelling long-term value in many new and seasoned assets, in spite of the price volatility that we and other market participants will continue to experience over the near term.

We deployed a significant amount of capital during the fourth quarter of 2007 (\$123 million), and we believe our rate of capital deployment could increase in 2008. The velocity of forced liquidations of seasoned assets at attractive prices by many financial institutions is increasing, and we expect new opportunities to arise to credit-enhance new loans originated to much higher-quality standards. We expect to continue financing these types of credit-sensitive

investments with capital, either on our own or with third-party capital sourced through opportunity funds or other asset management vehicles. Given the opportunities in front of us, we will likely seek to raise additional Redwood capital in 2008, assuming capital can be raised in a manner that is accretive to earnings given our planned capital uses.

## Outlook

We expect that over the next two to three years, we will likely experience delinquencies and credit losses that will increase materially on a percentage basis in comparison to the low levels we experienced over the last few years. We believe we have established appropriate reserves for these increased losses, however, and we expect most of our assets to produce healthy economic returns even with the increased losses that we currently anticipate. That being said, we do not know how long or how severe this credit cycle will be, and our current expectations about the level of future losses could be overly optimistic.

Overall, we believe the most appropriate expectation over the next few years is that credit losses will escalate and likely reduce the amount of our special dividends. In a severe case – a case that we are not expecting despite current market turmoil – taxable income alone may be less than our regular dividend for some period of time.

31

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### TABLE OF CONTENTS

On the positive side for Redwood, the real estate and capital markets excesses of the past continue to get wrung out of the system, which we believe will make for a positive longer-run future for us. Real estate is beginning to return to sound fundamentals, competition has been reduced, and there are some prospects for new forms of credit-enhancement to arise in the future where we could be competitive. Additionally, asset prices continue to fall, and assets are beginning to change hands after several months during which there was little market activity, so our search for new acquisition opportunities is becoming more interesting.

After a painful year for our industry, we believe we have emerged from 2007 as one of the companies best positioned to capitalize on the opportunities that lay ahead. The strength of our balance sheet allowed us to weather the current liquidity crisis and build for the future. Overall, we believe the long-term outlook for Redwood is favorable, although the near and medium-term will likely remain difficult. As a survivor and a leader, we will have an opportunity to define the new operating models in our space in the future.

## Mark-to-Market Adjustments Discussion

### Accounting and Economics

The rules regarding mark-to-market (MTM) accounting are complex and may not clearly reflect the underlying economics. This accounting and economic discussion is intended to provide investors with a better understanding of the impact of MTM adjustments on our reported financial results.

MTM adjustments can result from changes in fair values caused either by a change in expected cash flows (i.e. increased credit loss estimates reducing expected cash flows), or a change in market discount rates (i.e., the market requires a greater risk premium and/or interest rates rise), or a combination of both.

All changes in fair value for securities or derivatives accounted for as trading instruments flow through the income statement. These adjustments can be either positive or negative from period to period.



The vast majority of real estate securities held by Redwood and consolidated Acacia entities at December 31, 2007 were accounted for as available-for-sale (AFS) securities. We carry AFS securities in our GAAP balance sheet at their fair value. Positive changes in the fair value of AFS securities from period to period are always accounted for as increases to stockholders' equity and do not flow through our income statement. Accounting for negative changes in the fair value of AFS securities from period to period requires a three-step process involving a combination of quantitative and judgmental evaluations. The ultimate purpose of this process is to determine whether negative MTM adjustments represent other-than-temporary (OTT) impairments, which flow through our GAAP income statement, or represent temporary impairments, which are recorded as a reduction of stockholders' equity and do not flow through our income statement.

32

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TABLE OF CONTENTS

The diagram below and the narrative discussion that follow addresses the three-step process for evaluating impairments on AFS securities.

The first step in this process is to determine whether there has been an adverse change in the underlying cash flows generated by the security. A security is considered OTT impaired even if the change in projected cash flows is small relative to the resulting MTM adjustment. It is difficult to separate with precision how much of the change in fair value is driven by changes in expected cash flows versus changes in market discount rates, but during periods of market illiquidity and uncertainty (as we encountered in late 2007), the market discount rate impact can be significant.

The second step is to determine whether we have the ability and intention to hold the security.

The third step requires us to evaluate whether an impaired security will recover in value within a reasonable period of time. This step is very subjective and proved especially difficult this quarter in light of turmoil and uncertainty in the capital markets. We needed additional time to complete this step, and thus we requested a fifteen-day extension of the filing date of our annual report on Form 10-K. Over 70% of the total OTT impairments we recorded during the fourth quarter resulted from this third step of the process.

AFS securities deemed OTT impaired for accounting purposes cannot be written back up through MTM adjustments in our income statement. This does not mean the underlying security could not recover in value. If the value of an impaired security does recover, we would recognize this benefit through higher interest yields over time. Therefore, some of our securities which were classified as OTT impaired for accounting purposes during 2007 may eventually prove to have significant economic value to us.

We believe the MTM accounting rules applicable to the preparation of our 2007 financial statements caused our stockholders' equity to be significantly understated at December 31, 2007. We are required for accounting purposes to consolidate the Acacia CDO entities. As a result, the net GAAP carrying value of our investments in Acacia reflected in our financial statements is expressed as the difference between the carrying value of Acacia's assets and the carrying value of Acacia's liabilities (ABS issued to third parties). The MTM

33

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TABLE OF CONTENTS

accounting rules in place at December 31, 2007, required us to MTM Acacia's assets, but did not permit us to MTM Acacia's liabilities, even though the assets and liabilities are directly paired (i.e., the liabilities of an Acacia entity will

be repaid only from the cash flows generated by that entity's assets). Consequently, the GAAP net carrying value of our investments in Acacia entities was negative \$1.4 billion at December 31, 2007, a value that is impossible (as the economic value of our investments cannot be less than zero) and significantly understates our estimate of the economic value of our Acacia investments at that time.

In our opinion, the best economic method to assess the value of our investments in Acacia is to calculate the net present value of future expected cash flows of these investments. Our December 31, 2007 estimate of the sum of future expected cash flows from our investments in Acacia securities plus management fees we anticipate receiving from those entities was \$244 million. The net present value of these cash flows discounted at 45% was \$46 million.

We believe that \$46 million is a reasonable approximation of the economic value of our investments in Acacia at December 31, 2007. If we were permitted for accounting purposes to use the valuation methodology described above, GAAP and economics would be in sync, and our financial statements and disclosures would be less complicated.

On January 1, 2008, we adopted FAS 159 and elected to fair value both the assets and liabilities of the Acacia entities.

In accordance with FAS 159, we recorded a one-time, cumulative-effect adjustment to our balance sheet that decreased the carrying value of Acacia liabilities by \$1.5 billion and increased stockholders' equity by that amount in our January 1, 2008 balance sheet. Adoption of this new accounting standard significantly improves the substantial disparity that existed between the Acacia GAAP presentation and economics at December 31, 2007.

Discrepancies between economic and GAAP valuations of our Acacia investments will continue to occur because under FAS 159 the cash flow value of our investments is not taken into account in determining the carrying value of our investments. Instead, GAAP carrying value of our investments is derived by subtracting the fair value of Acacia's liabilities from the fair value of Acacia's assets. Furthermore, Acacia's assets and liabilities are valued separately in their independent markets. In theory, changes in the fair values of Acacia's assets and liabilities should be reasonably correlated as they are paired within the same legal structure -- ABS issued by each Acacia entity will be repaid directly and solely from the cash flows generated by the assets owned by that entity. However, at any given moment, the capital markets may use different discount rates and valuation parameters for Acacia's collateral assets relative to its ABS issued to third parties. On January 1, 2008, for instance, the market values for Acacia liabilities were, in our view, depressed relative to the paired collateral asset values. As a consequence of this market condition, when we fair valued the assets and liabilities of the Acacia entities under FAS 159 at January 1, 2008, the derived net GAAP carrying value of our Acacia investments was \$84 million. This result exceeded our \$46 million estimate of economic value of our investments in Acacia entities based on the net present value of expected cash flows.

As a consequence of adopting FAS 159, we will be required in the future to flow through our quarterly income statements the relative changes in the fair values of Acacia assets and liabilities as measured in their independent markets. There is no way to anticipate these relative changes from quarter to quarter. As a consequence, our earnings will vary as these values fluctuate over time. In particular, if Acacia liability values increase from the low levels at December 31, 2007, all or a portion of the \$38 million by which the GAAP carrying value at January 1, 2008 (\$84 million) exceeded our estimate of economic value (\$46 million) will flow through our income statement as negative MTM adjustments. There is no scheduled time frame when this excess may be absorbed. It could happen gradually over time, or it could happen in a single quarter.

## **Impact on Redwood**

The price declines in real estate securities in 2007 had a significant negative GAAP financial reporting impact on Redwood, as MTM adjustments to our consolidated real estate securities portfolio caused our GAAP book value and our GAAP earnings to decline significantly. As previously discussed, we believe the real economic effect of these MTM adjustments is significantly less than the impact shown under GAAP as a consequence of being required to MTM Acacia assets, but not being permitted to MTM the paired Acacia liabilities.

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TABLE OF CONTENTS

The tables below detail the total MTM adjustments by the underlying collateral type for the securities.

**Table 3 Total Mark-to-Market Adjustments by Underlying Collateral Type**

(In Millions)	2007			Total	MTM Percent <sup>(1)</sup>
	IGS	CES	OREI & Derivatives		
Residential					
Prime	\$(252 )	\$ (290 )	\$ 1	\$(541 )	(39.33 )%
Alt-a	(467 )	(168 )	(67 )	(702 )	(56.10 )%
Subprime	(192 )	(59 )	(11 )	(262 )	(52.62 )%
Residential total	(911 )	(517 )	(77 )	(1,505 )	
Commercial	(20 )	(156 )		(176 )	(29.19 )%
CDO	(167 )	(33 )		(200 )	(61.61 )%
Interest rate agreements & other derivatives			(44 )	(44 )	
Total Mark-to-Market Adjustments	\$(1,098 )	\$ (706 )	\$ (121 )	\$(1,925 )	

(1) This percentage represents the MTMs taken as a percentage of the reported market values at the beginning of the year, or purchase price if acquired during the year. It is intended to highlight the price declines by collateral type for the year ended December 31, 2007. These price declines are for our specific portfolio and may not be indicative of price declines in the market in general.

**Table 4 Non-GAAP Total Mark-to-Market Adjustments by Vintage**

December 31, 2007 (In Millions)	Vintage				Total
	2004 & Earlier	2005	2006	2007	
Acacia	\$ (200 )	\$ (315 )	\$ (742 )	\$ (339 )	\$ (1,596 )
Redwood	(65 )	(52 )	(108 )	(104 )	(329 )
Total Mark-to-Market Adjustments	\$ (265 )	\$ (367 )	\$ (850 )	\$ (443 )	\$ (1,925 )

*The purpose of this pro forma presentation is to show total mark-to-market adjustments for 2007 by vintage and by the amount that affected Redwood (separate from Acacia), Acacia, and Redwood on a consolidated basis. This is a non-GAAP presentation. The totals shown above are reconciled to GAAP in Table 5 below.*

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TABLE OF CONTENTS

The tables below show how these MTM adjustments on securities affected Redwood (separate from Acacia), Acacia, and Redwood on a consolidated basis. They also show the MTM adjustment amounts that flowed through our income statement and balance sheet.

## Table 5 Non-GAAP Pro Forma Balance Sheet and Income Statement Information    Mark-to-Market Adjustments

(In Millions)	2007 Redwood			Total
	Excluding Acacia	Sequoia	Acacia	
Balance Sheet Impact				
Reduction in stockholders' equity	\$ (158 )	\$	\$ (509 )	\$ (667 )
Income Statement Impact				
Market valuation adjustments				
Impairments on AFS securities	(144 )		(1,031 )	(1,175 )
Changes in fair value on trading instruments	(27 )		(56 )	(83 )
Total income statement impact	(171 )		(1,087 )	(1,258 )
Total Mark-to-Market Adjustments	(329 )		(1,596 )	(1,925 )

*The purpose of this pro forma presentation is to show the consolidating components for total mark-to-market adjustments for the year ended December 31, 2007. These mark-to-market adjustments are further detailed by the balance sheet (stockholders' equity) and income statement impact. This is a non-GAAP presentation. The total stockholders' equity impact of \$667 million for the year ended December 31, 2007 agrees with our consolidated balance sheet for the year. The total income statement impact of \$1.3 billion for the year ended December 31, 2007 agrees with our consolidated income statement for the year.*

Effective January 1, 2008, we elected to adopt the new accounting standard, FAS 159, that allows us to MTM both the assets and the liabilities of Acacia. We recorded a one-time cumulative adjustment to our opening balance for 2008 to reduce the carrying value of Acacia's liabilities by \$1.5 billion. After giving effect to this adjustment, the net MTM impact for 2007 was negative \$106 million. This impact is substantially less than the \$1.6 billion reflected in our consolidated financial statements.

Negative MTM adjustments on the securities at Redwood that were reflected as a reduction of stockholders' equity at December 31, 2007 (that is, gross unrealized losses that have not flowed through our income statement) were \$51 million for residential CES and \$43 million for commercial CES. If credit conditions continue to deteriorate in 2008, causing an adverse change in the expected cash flows from these securities, we could be required to flow through our income statement an impairment charge for a portion or for all of these negative MTM adjustments. It is important to note that those impairment charges would not impact our book value as the MTM adjustments were already deducted from stockholders' equity at December 31, 2007, but they would reduce our GAAP earnings in 2008.

### Mark-to-Market Valuation Process

The fair values we use in our mark-to-market process reflect what we believe we would realize if we chose to sell our securities or would have to pay if we chose to buy back our asset-backed securities (ABS) issued (liabilities).

Establishing fair values is inherently subjective and is dependent upon many market-based inputs, including observable trades, information on offered inventories, bid lists, and indications of value obtained from dealers. Valuations are especially difficult for more illiquid securities, such as the securities we own and our ABS issued, and when there is limited trading visibility, as was the case in recent months. For these reasons, we expect market valuations to continue to be highly volatile.

Fair values for the securities we own and our ABS issued are dependent upon a number of market-based assumptions including future interest rates, prepayment rates, discount rates, credit loss rates, and the timing of credit losses. We then use these assumptions to generate cash flow estimates and internal values for each individual security.

TABLE OF CONTENTS

We request indications of value (marks) from dealers every quarter to assist in the valuation process. For December 31, 2007, we received dealer marks on 87% of the assets and liabilities on our balance sheet and did not receive marks for the remaining 13%.

One of the factors we consider in our valuation process is our assessment of the quality of the dealer marks we receive. Dealers were overwhelmed with requests for 2007 year-end marks, and there was little observable trading information for them to rely upon. Thus, their marks were most likely generated by their own pricing models for which they did not share their inputs and we had little insight into their assumptions. Furthermore, the dealers now heavily qualify the information they send to us. The qualifications include the following:

credit markets have been characterized by significant volatility and very limited liquidity;  
the sharp downturn in trading levels for many securities has resulted in poor price transparency;  
valuations have become especially dependent on assumptions used in valuation models rather than observable inputs;  
valuations are indicative only and may not reflect the actual prices or spread levels at which the securities could be sold; and

valuations do not necessarily reflect the values that would be produced by other pricing models or methods.

Our valuation process relied on our internal values to estimate the fair values of our securities at December 31, 2007.

In the aggregate, our internal valuations of the securities on which we received dealer marks were \$298 million, or 14%, lower than the aggregate dealer marks at December 31, 2007. Our internal valuations of our ABS issued on which we received dealer marks were \$3 million, or less than 1%, lower than the aggregate dealer marks at December 31, 2007.

TABLE OF CONTENTS**Results of Operations: 2007 vs. 2006****Interest Income**

Total interest income consists of the interest earned on interest-bearing assets, adjusted for amortization of discounts and premiums and provisions for loan credit losses. The table below summarizes interest income earned on the following types of interest-bearing assets consolidated on our balance sheet: real estate loans, real estate securities, other real estate investments, non-real estate investments, and cash.

**Table 6 Interest Income and Yield**

(Dollars in Thousands)	Year Ended December 31, 2007				2006			
	Interest Income	Percent of Total Interest Income	Average Amortized Cost	Yield	Interest Income	Percent of Total Interest Income	Average Amortized Cost	Yield
	\$467,677	54.67 %	\$8,056,936	5.80 %	\$608,868	68.78 %	\$10,652,094	5.72 %

Real estate loans, net of provision for credit losses									
Real estate securities	364,023	42.55 %	3,599,396	10.11 %	265,353	29.98 %	2,612,934	10.15 %	
Other real estate investments	5,762	0.67 %	33,717	17.09 %					
Non-real estate investments	2,590	0.30 %	49,752	5.21 %					
Cash and cash equivalents	15,488	1.81 %	332,856	4.65 %	10,939	1.24 %	268,340	4.08 %	
Total Interest Income	\$855,540	100.00 %	\$12,072,658	7.09 %	\$885,160	100.00 %	\$13,533,368	6.54 %	

The table below details how our interest income changed by portfolio as a result of changes in consolidated asset balances ( volume ) and yield ( rate ) for 2007 as compared to 2006.

### Table 7 Volume and Rate Changes for Interest Income

(In Thousands)	Change in Interest Income Years Ended December 31, 2007 Versus December 31, 2006		
	Volume	Rate	Total Change
Real estate loans, net of provisions for credit losses	\$ (148,338 )	\$ 7,147	\$ (141,191 )
Real estate securities	100,179	(1,509 )	98,670
Other real estate investments	5,762		5,762
Non-real estate investments	2,590		2,590
Cash and cash equivalents	2,630	1,919	4,549
Total Interest Income	\$ (37,177 )	\$ 7,557	\$ (29,620 )

*Note: Volume change is the change in average volumes between periods multiplied by the rate earned in the earlier period. Rate change is the change in rate between periods multiplied by the average portfolio balance in the prior period. Interest income changes that resulted from changes in both rate and volume were allocated to the rate change amounts shown in the table. For investments we did not own in prior periods, the entire change was attributable to volume.*

Below is a further breakdown and discussion of the year-over-year changes for interest-bearing real estate loans, real estate securities, other real estate investments, and cash.

### Interest Income Real Estate Loans

The following tables provide detail on interest income earned on our residential and commercial real estate loan portfolios for 2007 and 2006.

### TABLE OF CONTENTS

### Table 8 Consolidated Real Estate Loans

Yield as a Result of

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Year Ended December 31,  
2007

(Dollars in Thousands)	Interest Income	Net (Premium) Discount Amortization	Provision For Credit Losses	Total Interest Income	Average Amortized Cost	Interest Income	(Premium) Discount Amortization and Credit Provision	Total Interest Income
Residential loans	\$516,848	\$(37,671)	\$(10,461)	\$468,716	\$8,030,563	6.44%	(0.60)%	5.84 %
Commercial loans	1,210	99	(2,348 )	(1,039 )	26,373	4.59%	(8.53)%	(3.94)%
Total Loans	\$518,058	\$(37,572)	\$(12,809)	\$467,677	\$8,056,936	6.43%	(0.63)%	5.80 %

Year Ended December 31,  
2006

(Dollars in Thousands)	Interest Income	Net (Premium) Discount Amortization	Reversal of Provision For Credit Losses	Total Interest Income	Average Amortized Cost	Interest Income	(Premium) Discount Amortization and Credit Provision	Total Interest Income
Residential loans	\$654,192	\$(48,700)	\$394	\$605,886	\$10,611,827	6.17%	(0.46)%	5.71 %
Commercial loans	2,849	168	(35 )	2,982	40,267	7.08%	0.33 %	7.41 %
Total Loans	\$657,041	\$(48,532)	\$359	\$608,868	\$10,652,094	6.18%	(0.46)%	5.72 %

### Residential Real Estate Loans

Total interest income on residential real estate loans decreased to \$469 million for 2007 from \$606 million for 2006. This was primarily a result of lower average balances of residential real estate loans and increased credit provisions in 2007 relative to 2006. Our residential real estate loan balance decreased to \$7.2 billion at December 31, 2007 from \$9.3 billion at December 31, 2006, as our loans paid down and we had a relatively low level of loan acquisitions. Of the \$7.2 billion of residential loans outstanding at December 31, 2007, 68% consisted of one or six-month LIBOR adjustable-rate residential loans (LIBOR ARMs). The level of short-term interest rates and the shape of the yield curve have an impact on the prepayment performance of LIBOR ARM loans. As the yield curve flattened and short-term interest rates rose beginning in early 2004, prepayments on these loans accelerated and, until recently, have generally prepaid at relatively fast speeds. In the second half of 2007, as the yield curve steepened and short-term interest rates began to fall, prepayments on LIBOR ARM loans slowed considerably. The average constant prepayment rate (CPR) for our LIBOR ARMs was 46% in the year ended December 31, 2006, 38% in the year ended December 31, 2007, and 27% on an annualized basis in the fourth quarter of 2007.

Loan premium amortization expense was \$38 million for 2007 and \$49 million for 2006. On a percentage basis, loan premium amortization expense for our LIBOR ARMs continues to lag the rate of decrease in our LIBOR ARM residential loan balance. The reason for this anomaly relates to the loan premium amortization method we use for loans acquired prior to July 2004, which represented 36% of the loan balance at December 31, 2007. For these loans, the premium amortization rate is somewhat influenced by prepayments, but is also influenced by short-term interest rates. As short-term rates increase, premium amortization slows; as short-term rates decrease, premium amortization potentially accelerates in a material way. See the Potential for GAAP Earnings Volatility below for further discussion. For the remainder of the loans (those acquired after July 2004), we use a different accounting method for premium amortization, where the percentage of amortization is more closely correlated to prepayment rates regardless of changes in short-term interest rates.

In 2007, we increased our provision for credit losses for residential loans by \$11 million. In 2006, we reduced our provision for credit losses for residential loans by less than \$1 million. As the residential loans on our consolidated balance sheet season and we do not acquire many new loans, we would expect to increase our credit reserve on a percentage basis, as we would expect our delinquencies to rise. On a percentage basis, our credit reserve increased to 0.26% of the residential loan balance at December 31, 2007 from 0.22% at December 31, 2006. Serious delinquencies (defined as those loans that are 90 days or more delinquent, in foreclosure or real estate owned) in residential loans have increased from 0.71% of the current loan balance at December 31, 2006 to 0.96% at December 31, 2007. As a percentage of original balance, serious delinquencies increased from 0.21% at December 31, 2006 to 0.24% at December 31, 2007.

39

## TABLE OF CONTENTS

### Commercial Real Estate Loans

Interest income on commercial real estate loans decreased by \$4 million for 2007 compared to the previous year. The majority of the decrease related to fully reserving for an anticipated loss on a mezzanine commercial loan financing a condominium-conversion project during the first quarter of 2007. Cost over-runs and changing market conditions make it probable that we will not collect any outstanding principal or accrued interest upon completion of the project. The total charge-off for this loan was \$3 million, of which \$2 million related to principal (and taken through the credit provision) and \$1 million to accrued interest (and taken as a reduction in interest income).

### Interest Income      Real Estate Securities

The tables below present the income and yields of the components of our real estate securities for 2007 and 2006.

**Table 9 Real Estate Securities      Interest Income and Yield**

Year Ended December 31, 2007	Yield as a Result of						
(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income
<b>IGS</b>							
Residential	\$128,398	\$7,428	\$135,826	\$2,038,545	6.30 %	0.36 %	6.66 %
Commercial	7,001	270	7,271	117,709	5.95 %	0.23 %	6.18 %
CDO	17,392	121	17,513	245,595	7.08 %	0.05 %	7.13 %
Total IGS	\$152,791	\$7,819	\$160,610	\$2,401,849	6.36 %	0.33 %	6.69 %
<b>CES</b>							
Residential	\$81,414	\$75,543	\$156,957	\$714,023	11.40 %	10.59 %	21.99 %
Commercial	43,446	271	43,717	457,803	9.49 %	0.06 %	9.55 %
CDO	2,872	(133 )	2,739	25,721	11.17 %	(0.52 )%	10.65 %
Total CES	\$127,732	\$75,681	\$203,413	\$1,197,547	10.67 %	6.32 %	16.99 %
Total Real Estate Securities	\$280,523	\$83,500	\$364,023	\$3,599,396	7.79 %	2.32 %	10.11 %

Year Ended December 31, 2006

Yield as a Result of



(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income
<b>IGS</b>							
Residential	\$86,181	\$6,874	\$93,055	\$1,393,736	6.18 %	0.49 %	6.67 %
Commercial	9,436	263	9,699	138,425	6.82 %	0.19 %	7.01 %
CDO	10,777	29	10,806	175,358	6.15 %	0.02 %	6.17 %
Total IGS	\$106,394	\$7,166	\$113,560	\$1,707,519	6.23 %	0.42 %	6.65 %
<b>CES</b>							
Residential	\$67,135	\$57,404	\$124,539	\$597,206	11.24 %	9.61 %	20.85 %
Commercial	26,961	(1,561 )	25,400	290,964	9.27 %	(0.54 )%	8.73 %
CDO	1,854		1,854	17,245	10.75 %		10.75 %
Total CES	\$95,950	\$55,843	\$151,793	\$905,415	10.60 %	6.17 %	16.77 %
Total Real Estate Securities	\$202,344	\$63,009	\$265,353	\$2,612,934	7.74 %	2.41 %	10.15 %

40

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## TABLE OF CONTENTS

### Investment-Grade Securities

Interest income from IGS increased to \$161 million in 2007 as compared to \$114 million in 2006, due primarily higher average balances of IGS in 2007. The majority of the IGS we acquired over the past year were residential, in part because comparably rated commercial securities traded at relatively higher prices and lower yields. The overall yield on our IGS portfolio increased during the year, reflecting increasing coupon rates on the underlying loans. The decrease in yields on commercial IGS in 2007 relative to 2006 was due to the sale of commercial IOs in 2006 owned by earlier Acacia entities.

### Residential Credit-Enhancement Securities

We acquire many first-loss securities at 25% to 35% of their principal value and other, more senior, credit-enhancement securities at 50% to 100% of their principal value. Many of these securities are priced at a substantial discount to their principal value since future credit losses could reduce or eliminate the principal value of these securities. Our yields on these investments depend on how much principal and interest we eventually collect and how quickly we receive those payments. The faster we collect principal and the longer it takes to realize credit losses, the better it is for our investment returns.

Interest income from our residential CES was \$157 million for 2007, a \$32 million increase over 2006. This increase is the result of higher yields and higher average balances. Most of our residential CES portfolio is backed by loans originated in 2005 and earlier. The credit performance on these loans has generally been better than our initial expectations, and this has contributed to higher yields than anticipated. Faster than anticipated prepayment rates on adjustable-rate mortgages (ARMs) have also contributed to higher levels of discount amortization. ARMs represented (by market value) 44% of our residential CES portfolio at December 31, 2007 and average actual prepayment rates were in excess of 34% in 2007 compared to our initial expectations (at the time of acquisition) of 20% to 25%.

We own residential real estate securities that are backed by option ARMs that give the borrower the option of making a minimum payment that is less than the amount of interest owed for that loan period. The unpaid interest is added to the loan balance creating negative amortization (neg am). The amount of neg am interest we currently recognize or defer for GAAP purposes on option ARM securities depends on our expectation of collectability. We currently expect that accumulated neg am interest for securities rated BB and higher will be paid in full. We currently do not expect to

collect the neg am interest on our unrated and B-rated securities. As a result, in both 2007 and 2006 we recognized \$5 million of neg am interest on securities rated BB and higher. During each of these time periods we deferred recognition of neg am interest of \$4 million on our unrated and B-rated securities backed by option ARMs. We will recognize any deferred interest on these securities only if and when cash is received. Our cumulative deferred neg am interest was \$8 million at December 31, 2007, an increase from \$4 million at December 31, 2006.

## Commercial Credit-Enhancement Securities

Interest income from our commercial CES was \$44 million for 2007, an \$18 million increase over 2006. This increase is primarily the result of significantly higher average balances. The average yield earned on our commercial CES portfolio for 2007 was 9.55%, an increase from 8.73% for 2006. For both 2007 and 2006, the yield was low relative to our other CES due to our credit loss assumptions. Similar to residential CES, commercial CES are acquired at a net discount. Commercial CES generally have a ten year maturity and are not expected to receive principal prepayments prior to maturity. As a result, it will take several years to further observe credit performance and re-assess our loss assumptions. A decrease in projected credit loss assumptions would result in higher yields (an increase in discount amortization) while increased loss assumptions would lead to lower yields or impairments.

41

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### TABLE OF CONTENTS

## Interest Income Other Real Estate Investments

The table below presents the interest income, average balance, and yield on our other real estate investments for 2007. We did not hold other real estate investments in 2006.

**Table 10 Other Real Estate Investments Interest Income and Yield**

(Dollars in Thousands)	Interest Income	Average Balance	Yield as a Result of Interest Income
Year Ended December 31, 2007	\$ 5,762	\$ 33,717	17.09 %

Other real estate investments consist of residential IOs, NIMs, and residuals. In prior years, these assets were included in real estate securities. The majority of the interest income was from residuals we purchased in the first half of 2007. Since we account for these assets as trading assets, the yield should be considered in conjunction with the market valuation adjustments recognized through the income statement on these assets, as discussed further later in this document.

## Interest Income Cash and Cash Equivalents

Interest income from cash and cash equivalents was \$15 million for 2007, an increase from \$11 million for 2006. Average cash balances were higher for 2007 as compared to 2006 as we had higher levels of excess capital. Yields were marginally higher for 2007 as compared to 2006.

## Interest Expense

Interest expense consists of interest incurred on consolidated ABS issued by sponsored securitization entities, Redwood debt, and Redwood subordinated notes.

The table below presents our interest expense and balances for these components for 2007 and 2006.

### Table 11 Total Interest Expense

(Dollars in Thousands)	Year Ended December 31,			
	2007			2006
Interest expense on consolidated ABS issued	\$ 580,955			\$ 671,445
Interest expense on Redwood debt	60,029			29,836
Interest expense on subordinated notes	10,778			423
Total Interest Expense on Total Obligations	\$ 651,762			\$ 701,704
Average balance of ABS issued	\$ 10,171,192			\$ 12,497,551
Average balance of Redwood debt	1,024,829			493,357
Average balance of subordinated notes	126,877			5,336
Average Total Obligations	\$ 11,322,898			\$ 12,996,244
Cost of funds of ABS issued	5.71	%	5.37	%
Cost of funds of Redwood debt	5.86	%	6.05	%
Cost of funds of subordinated notes	8.49	%	7.93	%
Total Cost of Funds of Obligations	5.76	%	5.40	%

Total consolidated interest expense decreased to \$652 million in 2007 from \$702 million in 2006. The primary reason relates to a decline in the average balance outstanding of ABS issued offset to some extent by higher average balances of Redwood debt and subordinated notes.

Interest expense on consolidated ABS decreased by \$90 million to \$581 million in 2007 from \$671 million in 2006.

The reduction in consolidated ABS interest expense was caused by a decline in the average balance of outstanding consolidated ABS issued as a result of prepayments of the loans within these securitization entities. Offsetting some of the decline in balances was the higher cost of funds due to an increase in short-term interest rates during the first nine months of 2007 as most of our debt and consolidated ABS issued is indexed to one, three, or six-months LIBOR.

These factors are illustrated in the volume and rate change table below.

42

### TABLE OF CONTENTS

Interest expenses on Redwood debt increased by \$30 million to \$60 million in 2007 from \$30 million in 2006 as a result of increased use of Redwood debt primarily during the first half of 2007. The average balance of our outstanding Redwood debt increased during 2007 due to a high level of financing for the acquisition of residential real estate loans and securities prior to the securitization of these assets through Sequoia and Acacia, (including from calling some older Sequoia loan securitizations) and financing of AAA and AA-rated real estate securities during the early part of the year.

Our subordinated notes (issued in 2006 and May 2007) pay interest expense at three-month LIBOR plus 225 basis points (2.25%). The cost of funds accrued on these notes includes the amortization of deal costs.

The table below illustrates the factors for the reduction in consolidated ABS interest expense.

## Table 12 Volume and Rate Changes for Interest Expense

(In Thousands)	Change in Interest Expense Years Ended December 31, 2007 vs. December 31, 2006		
	Volume	Rate	Total Change
Interest expense on ABS	\$ (124,986 )	\$ 34,496	\$ (90,490 )
Interest expense on Redwood debt	32,141	(1,948 )	30,193
Interest expense on subordinated notes	9,635	720	10,355
Total Interest Expense on Total Obligation	\$ (83,210 )	\$ 33,268	\$ (49,942 )

*Note: Volume change is the change in average balance of obligations between periods multiplied by the rate paid in the earlier period. Rate change is the change in rate between periods multiplied by the average outstanding obligations in the current period. Interest expense changes that resulted from changes in both rate and volume were allocated to the rate change amounts shown in the table.*

The table below presents the different components of our interest costs on ABS issued for 2007 and 2006. ABS issuance premiums are created when ABS are issued at prices greater than principal value, such as interest-only securities (IOs).

## Table 13 Cost of Funds of Asset-Backed Securities Issued

(Dollars in Thousands)	Year Ended December 31,			
	2007		2006	
ABS issued interest expense	\$575,363		\$667,061	
ABS issued issuance expense amortization	22,009		25,669	
Net ABS issued interest rate agreement income	(8,228 )	)	(12,472 )	)
Net ABS issued issuance premium income amortization	(8,189 )	)	(8,813 )	)
Total ABS Issued Interest Expense	\$580,955		\$671,445	
Average balance of ABS issued	\$10,171,192		\$12,497,551	
ABS issued interest expense	5.66	%	5.34	%
ABS issued issuance expense amortization	0.21	%	0.21	%
Net ABS issued interest rate agreement income	(0.08	)%	(0.10	)%
Net ABS issued issuance premium income amortization	(0.08	)%	(0.07	)%
Cost of Funds of ABS Issued	5.71	%	5.38	%

43

### TABLE OF CONTENTS

## Operating Expenses

Components of our operating expenses for 2007 and 2006 are presented in the table below.

## Table 14 Operating Expenses

(In Thousands)	Year Ended December 31,	
	2007	2006

Fixed compensation expense	\$ 17,779	\$ 13,871
Variable compensation expense	1,787	7,709
Equity compensation expense	12,249	11,498
Severance expense	3,720	
Total compensation expense	35,535	33,078
Systems	9,547	7,947
Due diligence	1,080	4,035
Office costs	5,200	4,278
Accounting and legal	3,674	3,533
Other operating expenses	3,519	3,054
Total Operating Expenses	\$ 58,555	\$ 55,925

Total operating expenses were \$59 million for 2007, an increase of \$3 million from 2006. The primary reason was an increase in compensation expense, although the various components of this expense either increased and decreased from last year's levels. There was severance expense as part of a realignment of residential and commercial operations in 2007 and no such expense in 2006. Fixed compensation expense includes employee salaries and related employee benefits. Our average headcount increased 20% in 2007 over 2006 levels and combined with salary increases in 2007 accounts for the 30% year over year increase in the fixed compensation. Variable compensation expense was significantly lower in 2007. Variable compensation expense includes employee bonuses which are based on the annual adjusted return on equity earned by Redwood and individual performance. The adjusted return on equity was below that required for company performance bonuses, to be earned in 2007. Equity compensation expense includes the cost of equity awards granted to employees and directors over the vesting period.

Non-compensation expenses were relatively the same in 2007 as in 2006. The ongoing office and system related costs were in line with our staffing growth. These increases were offset by a decrease in due diligence expenses as our acquisition activity was lower in 2007.

## Realized Gains on Sales and Calls

Total realized gains on sales and calls were lower for 2007 compared to 2006. The primary reason was the fact that prices on securities fell throughout 2007 and, as a result, we did not choose to exercise our call rights on eligible Acacia entities. In 2006, we called three Acacias, sold the underlying assets and recognized gains after paying back the related debt. Early in 2007, we called one Acacia and generated some gains. As prices on securities fell in the second half of 2007, the liquidity in the market also became restricted. Early in the second half of 2007, we decided to sell most of our AAA-rated securities funded with debt and did so at a loss, further contributing to the disparity in net (losses) gains on sales between 2007 and 2006.

In the second half of 2007, we acquired a few Acacia ABS at discounts relative to the issued price. Under GAAP accounting, these transactions generated a \$13 million gain which was the difference between our purchase price (\$16 million) and the outstanding amortized principal balance of the ABS acquired (\$29 million).

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### TABLE OF CONTENTS

The table below provides detail of the net realized gains on sales and calls for 2007 and 2006.

## Table 15 Realized Gains on Sales and Calls, Net

Year Ended December 31,

(In Thousands)	2007	2006
Realized gains (losses) on sales of:		
Real estate loans	\$ 678	\$ (14 )
Real estate securities	(6,147 )	11,205
Interest rate agreements	439	8,386
Total (losses) gains on sales	(5,030 )	19,577
Total gains on repurchase of Acacia ABS	12,500	
Total gains on calls of residential CES	5,311	2,980
Total Realized Gains on Sales and Calls, Net	\$ 12,781	\$ 22,557

### Market Valuation Adjustments

Market valuation adjustments reflect those changes in fair values of assets that we recognize through our income statement. These include changes in the fair value of our trading instruments (other real estate investments, non-real estate investments, credit default swaps, and certain interest rate agreements), the write-downs of assets that are impaired under the provisions of EITF 99-20, EITF 03-01, and SAB 59 and the change in the value of our purchase commitments.

The table below provides the components of realized valuation adjustments for 2007 and 2006. Other than certain interest rate agreements, we did not have any assets accounted for as trading instruments in 2006.

### Table 16 Market Valuation Adjustments, Net

(In Thousands)	Year Ended December 31,	
	2007	2006
Changes in fair value of trading instruments		
Other real estate investments		
Residuals	\$ (15,223 )	\$
NIMs	(9,436 )	
IOs	1,050	
Total other real estate investments	(23,609 )	
Derivative financial instruments		
Credit default swaps	(54,113 )	
Interest rate agreements	(4,112 )	(5,731 )
Purchase commitments	(1,119 )	(24 )
Total changes in derivative financial instruments	(59,344 )	(5,755 )
Total changes in fair value of trading instruments	(82,953 )	(5,755 )
Lower of cost or market adjustments on real estate loans	(2,978 )	
Other than temporary impairments	(1,175,518)	(6,831 )
Total Market Valuation Adjustments, Net	\$ (1,261,449)	\$ (12,586 )

Our portfolio of other real estate investments (OREI) accounted for as trading instruments was \$12 million at December 31, 2007. We did not own any OREI at December 31, 2006. Due to the implementation of a new accounting standard, Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Investments* (FAS 155) in the first quarter of 2007, we elected at the end of the first quarter to classify certain securities (IOs, NIMs, and residuals) that contain embedded derivatives as trading instruments. Under previous GAAP guidance, we had classified these securities as available-for-sale (AFS). The fair value of these OREI declined in 2007 by \$24 million as spreads widened considerably as a result of the dislocation of the residential mortgage-backed securities market.

## TABLE OF CONTENTS

Credit default swaps held in our Acacia securitizations are derivatives and accounted for as trading instruments. The fair value of these credit default swaps decreased \$54 million in 2007 as spreads widened out and prices fell on the underlying securities that these credit default swaps referenced.

The fair values of those interest rate agreements accounted for as trading instruments decreased by \$4 million during 2007. All changes in fair values, whether positive or negative, of these particular interest rate agreements are recognized through the income statement. We use interest rate agreements to manage our interest rate risks. The changes in the fair value of the hedged asset or liability may not be reported through our income statement. Consequently, our use of interest rate agreements accounted for as trading instruments, could lead to volatile reported earnings even when they are accomplishing the goal of hedging some of our interest rate risks.

We recorded negative \$3 million of market valuation adjustments on our held-for-sale residential real estate loans during 2007 as these are reported on our balance sheet at the lower of cost of market (LOCOM). Once transferred from held-for-investment to held-for-sale the loans are required to be revalued quarterly and recorded at LOCOM. Write-downs to current market value once in the held-for-sale category are recorded through the income statement. We had no held-for-sale loans during 2006.

For accounting purposes, securities are deemed impaired if the fair value is below amortized cost. An assessment is then required as to whether the impairment is temporary and is reflected as unrealized losses in the balance sheet, or is other-than-temporary and realized through the income statement as market valuation adjustments. The assessment of other-than-temporary impairments requires a determination of whether there has been an adverse change in the underlying cash flows generated by a security, whether we have the intent and ability to hold the security, and whether we believe the impaired security will recover its value within a reasonable period of time. This is a highly complex and subjective evaluation.

Based on our assessment, we recorded \$1.2 billion of other-than-temporary impairments through our income statement in 2007 with \$1.1 billion of this amount recorded in the fourth quarter. The majority of these fourth quarter impairments (over 70%) were due to our assessment that the values of many types of securities would not recover within a reasonable period of time.

## **Other Comprehensive (Loss) Income**

Most of our real estate securities are accounted for as AFS and are reported on our consolidated balance sheets at fair value. Many of our derivative instruments are accounted for as cash flow hedges and are also reported on our consolidated balance sheets at fair value. The differences between the value of these assets and our amortized cost are shown as a component of stockholders' equity as accumulated other comprehensive (loss) income. Periodic changes in the fair value of these assets relative to amortized cost are included in other comprehensive (loss) income.

As a result of the spread widening on real estate securities that occurred during 2007, the fair value adjustments recorded on our consolidated balance sheet on AFS assets was negative \$1.4 billion. The table below provides the change during 2007 and cumulative balances of unrealized gains and losses and carrying value by type of real estate securities and by IGS and CES at December 31, 2007 and 2006.

## TABLE OF CONTENTS

**Table 17 Other Comprehensive (Loss) Income Real Estate Securities**

(In Thousands)	Cumulative Unrealized		Change in (Loss) Gain Year Ended December 31, 2007	Carrying Value	
	December 31, 2007	December 31, 2006		December 31, 2007	December 31, 2006
Investment Grade Securities					
Residential	\$(240,538)	\$ 5,025	\$(245,563)	\$1,157,464	\$1,697,250
Commercial	(20,229 )	111	(20,340 )	89,676	119,613
CDO	(12,750 )	2,174	(14,924 )	113,619	224,349
Total IGS	(273,517)	7,310	(280,827)	1,360,759	2,041,212
Credit Enhancement Securities					
Residential	(143,510)	58,015	(201,525)	401,945	721,531
Commercial	(124,948)	21,081	(146,029)	336,835	448,060
CDO	822	122	700	10,541	21,964
Total CES	(267,636)	79,218	(346,854)	749,321	1,191,555
Total Real Estate Securities	\$(541,153)	\$ 86,528	\$(627,681)	\$2,110,080	\$3,232,767
Tax effect of unrealized gains in prior periods			343		
Total Other Comprehensive (Loss) Income on Real Estate Securities			\$(627,338)		

There is no net tax effect of unrealized losses at December 31, 2007 as a result of an offsetting valuation allowance of \$12 million against a deferred tax asset of \$12 million, both recorded through other comprehensive (loss) income. See the discussion in *Note 15* for a further explanation of deferred tax assets.

The change in the fair market valuation adjustment recorded on the balance sheet of our interest rate agreements was negative \$40 million.

**Taxes****Provisions for Income Taxes**

As a REIT, we are able to pass through substantially all of our earnings generated at our REIT to stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries.

Our income tax provision in 2007 was \$5 million, a decrease from the \$10 million income tax provision recorded in 2006, primarily due to a decline in net income, particularly at our taxable subsidiaries.

**Taxable Income and Dividends**

In 2007, we earned an estimated \$164 million of total taxable income, or \$5.79 per share. Of this amount, \$161 million was earned at the REIT and \$3 million was earned at our taxable subsidiaries. Total taxable income is not a measure calculated in accordance with GAAP; it is the pre-tax income calculated for tax purposes. REIT taxable income is that portion of our taxable income that we earn at Redwood Trust and its qualifying REIT subsidiaries and does not include taxable income earned in taxable subsidiaries. Estimated REIT taxable income is an important measure as it is the basis of our required dividend distributions to stockholders.



Taxable income calculations differ from GAAP income calculations in a variety of ways. The most significant differences include the timing of amortization of premium and discounts and the timing of the recognition of gains or losses on assets. The rules for both GAAP and tax accounting for loans and securities are technical and complicated and the impact of changing interest rates, actual and projected prepayment rates, and actual and projected credit losses can have a very different impact on the amount of GAAP and tax income recognized in any one period. See the discussions under Potential GAAP Earnings Volatility and Potential Tax Earnings Volatility below for further information on this topic.

47

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### TABLE OF CONTENTS

Total estimated taxable income of \$164 million was less than the \$175 million earned in 2006 by \$11 million. This decrease was the result of an increase in credit losses on CES of \$7 million, \$10 million in write-offs of interest-only certificates resulting from the call of Sequoia securitizations, \$4 million of losses on commercial assets, and lower gains of \$2 million from sales and calls. These decreases were partially offset by lower equity compensation expenses of \$8 million in 2007.

The table below reconciles GAAP income to total taxable income for 2007 and 2006.

### **Table 18 Differences Between GAAP Net Income and Total Taxable Income**

(In Thousands, Except Per Share Data)	Year Ended December 31,	
	2007	2006
GAAP net (loss) income	\$ (1,108,637 )	\$ 127,532
Difference in taxable income calculations		
Amortization and credit losses	16,811	44,016
Operating expense differences	2,695	(8,218 )
Realized gains on calls and sales	(10,797 )	(7,952 )
Market valuation adjustments, net	1,261,449	12,586
Income tax provisions	2,874	7,090
Total differences in GAAP/tax income	1,273,032	47,522
Taxable Income	\$ 164,395	\$ 175,054
Shares used for taxable EPS calculations	28,392	25,934
Total Taxable Income Per Share	\$ 5.79	\$ 6.75

Our taxable income estimates are based on a number of assumptions regarding future events. To the extent such events do not occur, or other events occur which we have not anticipated, our quarterly estimates could change and could be significantly different quarter over quarter. See the discussion in Potential Tax Income Volatility below.

Our board of directors declared regular dividends of \$0.75 per share for each of the four quarters of 2007 and a 2007 special dividend of \$2.00 per share. As in the past few years, we permanently retained 10% of our 2007 taxable REIT income and deferred the distribution of a portion of our taxable REIT income to shareholders into the subsequent year. At December 31, 2007, there was \$49 million (\$1.52 per share) of 2007 undistributed estimated REIT taxable income that we plan to distribute to our shareholders during the first two quarters of 2008.

We continue to be in compliance with all REIT tests. We generally attempt to avoid acquiring assets or structuring financings or sales at the REIT that could generate unrelated business taxable income or excess inclusion income that would be distributed to our shareholders or that would cause prohibited transaction taxes on the REIT. There can be no assurance that we will be successful in doing so.

## Potential GAAP Earnings Volatility

We expect quarter-to-quarter GAAP earnings volatility for a variety of reasons, including the timing of sales and calls of assets, changes in interest rates, prepayments, credit losses, changes in fair values of assets and liabilities, and capital utilization. In addition, volatility may occur because of technical accounting issues, some of which are described below.

### Loan Premium Amortization

Our unamortized loan premium on our consolidated residential real estate loans at December 31, 2007 was \$86 million. This will be expensed over the remaining life of these loans. Amortization for a significant portion of this premium balance is driven by effective yield calculations that depend on interest rates and prepayments (see Critical Accounting Policies for further details). Loan premium amortization was \$38 million and \$49 million in 2007 and 2006, respectively. Declines in short-term interest rates and increases in prepayments could cause a significant increase in required amortization in subsequent periods.

In addition, premium amortization expense acceleration could occur if we reclassify a portion of the underlying loans from held-for-investment to held-for-sale, as the GAAP carrying value of these loans is

48

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### TABLE OF CONTENTS

currently in excess of their fair value. This reclassification could occur as the various underlying pools of loans become callable and we decide to sell these loans, or it could occur if there is a change in accounting principles.

### Changes in Fair Values on Real Estate Securities

Currently, all of our IGS and CES are classified as AFS and are carried on our consolidated balance sheets at their estimated fair values. Cumulative unrealized gains and losses are reported as a component of accumulated other comprehensive (loss) income in our consolidated statements of stockholders' equity. However, adverse changes to projected cash flows related to poor credit performance, adverse changes to prepayment speeds, or our decision to sell assets could create an other-than-temporary impairment for accounting purposes and could cause declines in fair values to be reported through our income statement as market valuation adjustments.

At December 31, 2007 we had \$2.1 billion of securities on our consolidated balance sheet. Of these, \$226 million were backed by subprime loans (\$10 million of CES and \$216 million of IGS) and \$527 million were backed by option ARMs (\$85 million of prime CES, \$197 million of prime IGS, \$67 million of alt-a CES, and \$178 million alt-a IGS). In the event future credit performance on our CES securities is worse than our current projections, we would be required to report losses through our income statement. See the Financial Condition discussion later in this document for further detail on these securities.

As of January 1, 2008 we elected the fair value option under FAS 159 for the consolidated assets and liabilities of Acacia. See below for a discussion on the potential impact to GAAP earnings of this election.

### Changes in Fair Values in Other Real Estate Investments

Other real estate investments (IOs, NIMs, and residuals) typically contain embedded derivatives that require bifurcation and separate valuation through the income statement under FAS 155. We have elected to treat these investments as trading instruments rather than bifurcate the embedded derivative component. Trading instruments are

required to be reported on our consolidated balance sheet at their estimated fair values with changes in fair values reported through our consolidated statements of income (loss) through market valuation adjustment. Marking to market the security rather than just the embedded derivative component will likely increase GAAP earnings volatility going forward. Under previous GAAP guidance, we classified these securities as AFS. We may classify other assets as trading instruments or may elect the fair value option under FAS 159 for certain of our future acquisitions (see below).

### **Changes in Fair Values of Derivative Financial Instruments**

To date, we have elected two classifications for derivative instruments: trading instruments and cash flow hedges. All derivative instruments, regardless of classification, are reported on our consolidated balance sheets at fair value. Changes to the fair values of the derivatives classified as trading instruments are recognized through the consolidated statements of income (loss). For those derivatives accounted for as cash flow hedges, the changes in fair values are reported through our consolidated balance sheets with only the ineffective portions (as determined according to the accounting provisions) reported through our income statement.

We could experience significant earnings volatility from our use of derivatives. This could occur, for example, when changes in the fair values of the derivatives are reported through our income statement but changes in the fair values in the hedged assets or liabilities are not recognized in a similar manner. Earnings volatility could also occur as we expand our use of derivatives (including acquiring derivatives as investments and not just as hedging instruments).

### **Changes in Accounting Principles**

As of January 1, 2008 we elected the fair value option for all assets, derivatives, and liabilities in Acacia and we also plan to elect the fair value option for certain new acquisitions. See the Critical Accounting Policy section for a discussion of the potential impact of this election under FAS 159.

These fair value option elections under FAS 159 could lead to further GAAP volatility as we will now mark-to-market through the income statement each quarter all of the assets and liabilities of Acacia and certain other assets and liabilities. The market value of even paired assets and liabilities may not move in tandem in any one quarter. Thus, even if the liabilities can only be paid from the cash flows of the collateral assets (as in the Acacia securitization entities), we may report significant income or loss in a period.

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## TABLE OF CONTENTS

### **Potential Tax Income Volatility**

Taxable income may vary from quarter to quarter based on many reasons, three of which are discussed below.

#### **Credit Losses**

To determine taxable income we are not permitted to anticipate, or reserve for, credit losses. Taxable income can only be reduced when credit losses occur. As a consequence, we are required to accrete the entire purchase discount on CES into taxable income over their expected life. For GAAP purposes, we do anticipate credit losses and only accrete a portion of the purchase discount into income. Additionally, for GAAP we write-down these securities when they become impaired. As a result, our income recognition on CES is faster for tax as compared to GAAP, especially in the early years of owning the assets (when there are generally few credit losses). At December 31, 2007, the cumulative difference between the GAAP and tax amortized costs basis of our residential, commercial, and CDO CES was \$242

million. In addition, as of December 31, 2007, we had a credit reserve of \$18 million for GAAP on our residential and commercial loans, and we recorded a \$3 million write-down on a commercial loan for tax. As of December 31, 2007, we had an \$8 million reserve for accrued interest on securities backed by option ARMs for GAAP and no corresponding reserve on this income for tax. As we have no credit reserves for tax and a higher CES basis, any future credit losses on our CES or loans would have a more significant impact on tax earnings as compared to GAAP and may create significant taxable income volatility to the extent the level of credit losses varies during periods.

### **Income Recognition on Sequoia Interest-Only Securities (IOs)**

As a result of rapid prepayments, we are experiencing negative economic returns on some IOs we acquired from prior Sequoia securitizations. For tax purposes, however, we are not permitted to recognize a negative yield, so premium amortization expenses for tax have not been as high as they otherwise would have been based on the economic returns. As a result, our current tax basis of \$75 million on these IOs is higher than the fair value. Many of our Sequoia securitization entities are currently callable and others will become callable over the next two years. Depending on prevailing market conditions, we may call certain securitizations, at which time the IO tax basis at that time will be written off and an ordinary loss for tax will be realized. The actual losses will depend on the tax basis at the time of any calls as the monthly cash flows received on these IOs in the interim will reduce their tax basis. At this time, we do not anticipate calling any Sequoia deals in 2008. Our taxable earnings will vary from period to period based on the exact timing of these Sequoia calls.

### **Compensation Expense**

Compensation expense for tax varies depending on the timing of dividend equivalent rights payments, the exercise of stock options, the distribution of deferred stock units, and deferrals to and withdrawals from our executive deferred compensation plan. For the most part, for GAAP, the total expense associated with an award is determined at the award date and is recognized over the vesting period. For tax, the expense is recognized at the date of distribution or exercise. This leads to the possibility that the total expense related to equity awards could be significantly different for GAAP than for tax in addition to the differences in timing.

50

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## TABLE OF CONTENTS

### **Results of Operations: 2006 vs. 2005**

Our reported GAAP net income was \$128 million (\$4.85 per share) for 2006. Our GAAP net income was \$200 million (\$7.96 per share) in 2005 and was \$233 million (\$10.47 per share) in 2004. Our GAAP return on equity was 13% for 2006 compared to 21% for 2005 and 32% for 2004. In 2006, we declared four regular quarterly dividends of \$0.70 per share and a special dividend of \$3.00 per share.

The largest factor in the decline in net income for 2006 as compared to 2005 was a \$43 million drop in income from gains generated on the sale and call of assets. In 2005, we sold a significant amount of CES as part of a portfolio management strategy to reduce our level of residential credit risk and to free up capital. We also benefited from a large number of calls of securities in 2005. Another factor contributing to the decline in earnings was a decrease in net interest income of \$21 million primarily due to high prepayments on adjustable-rate loans securitized under our Sequoia program. This decline was partially offset by an increase in yields from our securities portfolio (primarily residential CES). Other factors include an increase of operating expenses of \$8 million and an increase in negative mark-to-market valuation adjustments of \$8 million primarily related to interest rate agreements. The assets associated with these interest rate agreements generally increased in value, but those increases were not recognized in GAAP income. These items were partially offset by a decrease in the tax provision of \$8 million due to a decrease in net

income.

In 2006, we raised \$66 million of capital through the sale of common stock via our direct stock purchase plan and we raised \$100 million of capital from the sale of trust preferred securities. Additionally, we freed up \$97 million of capital for investment by selling and re-securitizing a portion of our CES. We absorbed all of this capital in 2006, primarily through new investments in commercial and residential CES and investment-grade securities. At year end 2006, we had \$182 million of excess capital, \$7 million less than at the beginning of the year.

At 2006 year-end, we had over \$2 billion of residential and commercial securities funded through our Acacia CDO program.

We owned \$518 million subprime investment-grade securities at year-end 2006 and most of them were financed via Acacia CDO securitization. Over 90% of these securities were rated BBB+ or higher. We owned \$44 million of 2006 subprime BBB- and BBB securities at year-end 2006.

## Interest Income

Total interest income consists of interest earned on consolidated earning assets, adjusted for amortization of discounts and premiums and provisions for loan credit losses. The table below summarizes interest income earned on real estate loans, securities, and cash.

**Table 19 Interest Income and Yield**

(Dollars in Thousands)	Year Ended December 31, 2006				2005			
	Interest Income	Percent of Total Interest Income	Average Amortized Cost	Yield	Interest Income	Percent of Total Interest Income	Average Amortized Cost	Yield
Real estate loans, net of provision for credit losses	\$608,868	68.78 %	\$10,652,094	5.72 %	\$779,469	81.01 %	\$18,694,028	4.17 %
Real estate securities	265,353	29.98 %	2,612,934	10.15 %	177,524	18.45 %	2,173,295	8.17 %
Other real estate investments								
Non-real estate investments								
Cash and cash equivalents	10,939	1.24 %	268,340	4.08 %	5,204	0.54 %	181,259	2.87 %
Total Interest Income	\$885,160	100.00 %	\$13,533,368	6.54 %	\$962,197	100.00 %	\$21,048,582	4.57 %

51

## TABLE OF CONTENTS

The table below details how our interest income changed by portfolio as a result of changes in consolidated asset balances ( volume ) and yield ( rate ) for 2006 as compared to 2005.

**Table 20 Volume and Rate Changes for Interest Income**

(In Thousands)	Change in Interest Income Years Ended December 31, 2006 Versus December 31, 2005		
	Volume	Rate	Total Change
Real estate loans, net of provisions for credit losses	\$ (335,318 )	\$ 164,717	\$ (170,601 )
Real estate securities	35,912	51,917	87,829
Other real estate investments			
Non-real estate investments			
Cash and cash equivalents	2,526	3,209	5,735
Total Interest Income	\$ (296,880 )	\$ 219,843	\$ (77,037 )

*Volume change is the change in average portfolio balance between periods multiplied by the rate earned in the earlier period. Rate change is the change in rate between periods multiplied by the average portfolio balance in the prior period. Interest income changes that result from changes in both rate and volume were allocated to the rate change amounts shown in the table.*

A further breakdown and discussion of the year over year changes for the real estate loan, real estate securities, and cash components of interest income follows below.

**Interest Income Loans**

The following table provides detail on interest income earned on our residential and commercial real estate loan portfolios for 2006 and 2005.

**Table 21 Consolidated Real Estate Loans**

Year Ended December 31, 2006	Yield as a Result of							
(Dollars in Thousands)	Interest Income	Net (Premium) Discount Amortization	Reversal of Provision For Credit Losses	Total Interest Income	Average Amortized Cost	Interest Income	(Premium) Discount Amortization and Credit Provision	Total Interest Income
Residential loans	\$654,192	\$(48,700)	\$394	\$605,886	\$10,611,827	6.17%	(0.46)%	5.71%
Commercial loans	2,849	168	(35)	2,982	40,267	7.08%	0.33%	7.41%
Total Loans	\$657,041	\$(48,532)	\$359	\$608,868	\$10,652,094	6.18%	(0.46)%	5.72%

Year Ended December 31, 2005	Yield as a Result of							
(Dollars in Thousands)	Interest Income	Net (Premium) Discount Amortization	Reversal of Provision For Credit Losses	Total Interest Income	Average Amortized Cost	Interest Income	(Premium) Discount Amortization and Credit Provision	Total Interest Income

Residential loans	\$819,113	\$(45,174)	\$245	\$774,184	\$18,642,020	4.39 %	(0.24)%	4.15 %
Commercial loans	5,450	(350 )	185	5,285	52,008	10.48%	(0.32)%	10.16%
Total Loans	\$824,563	\$(45,524)	\$430	\$779,469	\$18,694,028	4.41 %	(0.24)%	4.17 %

52

---

TABLE OF CONTENTS

Interest income on real estate loans decreased to \$609 million in 2006 from \$779 million in 2005 primarily as a result of lower average balances of real estate loans. This was due to high prepayments within our existing portfolio of LIBOR-indexed ARMs and a relatively low level of new loan acquisitions in 2006. This decline was partially offset by increased yields due to increases in the short-term interest rates to which most of the residential real estate loans are indexed.

Our residential real estate loan balance was \$22.5 billion at December 31, 2004, \$13.9 billion at December 31, 2005, and \$9.3 billion at December 31, 2006. The vast majority of these loans were one- and six-month LIBOR adjustable-rate residential loans (LIBOR ARMs) that were financed through our Sequoia securitization program. The flattening of the yield curve that began in 2005 and continued through 2006 led to fast prepayments on our existing LIBOR ARMs and caused origination levels of new LIBOR ARMs to significantly decline. In a flat yield curve environment, hybrid or fixed-rate loans are a more attractive loan alternative. Additionally, new forms of adjustable-rate mortgages (negative amortization, option ARMs, and moving treasury average ARMs) represent an increased share of the ARM market. Prepayment rates for our residential loans increased from an average constant prepayment rate (CPR) of 43% in 2005 to an average CPR of 46% in 2006.

Loan premium amortization expense increased to \$49 million in 2006 from \$46 million in 2005. The percentage increase in premium amortization expense was not commensurate with the decrease in our residential loan balance during this period. The reason for this anomaly relates to the loan premium amortization method we use for loans acquired prior to July 2004, which represented 71% of the loan balance at December 31, 2005 and 56% of the loan balance at December 31, 2006. For these loans, the premium amortization rate is somewhat influenced by prepayments, but is more significantly influenced by short-term interest rates. As short-term rates increase, premium amortization slows; as short-term rates decrease, premium amortization could accelerate in a material way. See the Potential for GAAP Earnings Volatility discussion later in this document. For the remainder of the loans which we acquired after July 2004, we use a different accounting method for premium amortization, and as a result, the percentage of amortization is more closely correlated to prepayment rates.

During 2006, we reversed \$0.4 million of our existing loan credit reserve into income. On a percentage basis, the reduction in the credit reserve was lower than the overall decline in our outstanding residential loan balance. The primary reason was a rise in residential loan delinquencies, which increased from 0.27% of the current loan balance at December 31, 2005 to 0.81% at December 31, 2006. This increase in delinquencies is in line with our expectations as our loan portfolio seasons. Delinquencies as a percent of original balances increased from 0.13% at December 31, 2005 to 0.24% at December 31, 2006. Overall, residential loan credit performance remains significantly better than our original expectations.

53

---

TABLE OF CONTENTS

## Interest Income    Securities

The tables below present the income and yields of the components of our securities for 2006 and 2005.

**Table 22 Real Estate Securities Interest Income and Yield**

Year Ended December 31, 2006		Yield as a Result of						
(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income	
<b>IGS</b>								
Residential	\$86,181	\$6,874	\$93,055	\$1,393,736	6.18 %	0.49 %	6.67 %	
Commercial	9,436	263	9,699	138,425	6.82 %	0.19 %	7.01 %	
CDO	10,777	29	10,806	175,358	6.15 %	0.02 %	6.17 %	
Total IGS	\$106,394	\$7,166	\$113,560	\$1,707,519	6.23 %	0.42 %	6.65 %	
<b>CES</b>								
Residential	\$67,135	\$57,404	\$124,539	\$597,206	11.24 %	9.61 %	20.85 %	
Commercial	26,961	(1,561 )	25,400	290,964	9.27 %	(0.54 )%	8.73 %	
CDO	1,854		1,854	17,245	10.75 %		10.75 %	
Total CES	\$95,950	\$55,843	\$151,793	\$905,415	10.60 %	6.17 %	16.77 %	
Total Real Estate Securities	\$202,344	\$63,009	\$265,353	\$2,612,934	7.74 %	2.41 %	10.15 %	

Year Ended December 31, 2005		Yield as a Result of						
(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income	
<b>IGS</b>								
Residential	\$58,029	\$3,835	\$61,864	\$1,158,785	5.01 %	0.33 %	5.34 %	
Commercial	12,648	(190 )	12,458	202,594	6.24 %	(0.09 )%	6.15 %	
CDO	7,261	15	7,276	138,207	5.25 %	0.01 %	5.26 %	
Total IGS	\$77,938	\$3,660	\$81,598	\$1,499,586	5.20 %	0.24 %	5.44 %	
<b>CES</b>								
Residential	\$47,286	\$36,540	\$83,826	\$522,704	9.05 %	6.99 %	16.04 %	
Commercial	12,269	(798 )	11,471	142,850	8.59 %	(0.56 )%	8.03 %	
CDO	581	48	629	8,155	7.12 %	0.59 %	7.71 %	
Total CES	\$60,136	\$35,790	\$95,926	\$673,709	8.93 %	5.31 %	14.24 %	
Total Real Estate Securities	\$138,074	\$39,450	\$177,524	\$2,173,295	6.35 %	1.82 %	8.17 %	

**Investment-Grade Securities**

Over the past year we shifted strategy to allocate more capital to investments in investment-grade securities (IGS) securities with less concentrated credit risks. Interest income from IGS increased in 2006 as compared to 2005 due to portfolio growth and increased yields. The majority of the IGS acquired in 2006 were residential, in part because comparably rated commercial securities traded at relatively higher prices and lower yields. The increase in yield is generally reflective of the rise in short-term interest rates over the past year, as new securities were purchased in a higher interest rate environment and many existing securities have a variable interest rate that reset to higher levels.

Most of the IGS acquired in 2006 were financed through our Acacia CDO securitization program.



## Residential CES

We acquire many first-loss bonds at 25% to 35% of their principal value and other, more senior, credit-enhancement securities at 50% to 100% of their principal value. Many of these securities are priced at a substantial discount to their principal value as future credit losses could reduce or eliminate the principal value of these securities. Our yields on these investments depend on how much principal and interest we eventually collect and how quickly we receive those payments. The faster we collect principal and the longer it takes to realize credit losses, the better it is for our investment returns.

Interest income from our residential CES was \$125 million in 2006, a \$41 million increase over 2005. This increase is largely the result of higher yields (21% in 2006 vs. 16% in 2005), which resulted from the

54

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### TABLE OF CONTENTS

strong credit performance and faster than anticipated prepayments rates on CES on the underlying ARM loans. ARMs represented 57% of our residential CES portfolio, and average actual prepayment rates were in excess of 40% in 2006 compared to our initial expectations (at the time of acquisition) of 20% to 25%.

The increase in interest income also resulted from a higher average balance of residential CES in our portfolio. This growth reflected our ability to find new assets at a pace in excess of our sales, calls, and principal payments.

### **IGS and CES Backed by Option ARMs**

We own IGS and CES that are backed by option ARM mortgages, which give the borrower the option of making a minimum payment that is less than the amount of interest owed for that loan period. The unpaid interest is added to the loan balance creating negative amortization (neg am). The amount of neg am interest we currently recognize or defer for GAAP purposes on option ARMs securities depends on our expectation of collectability. We currently expect that accumulated neg am interest for securities rated BB and higher will be paid in full. We will continue to monitor and assess this assumption.

In 2006 and 2005, we recognized \$7 million and \$1 million, respectively, of neg am interest on securities rated BB and higher. During these same time periods, we deferred recognition of neg am interest of \$4.0 million and \$0.8 million, respectively, on our unrated and B-rated securities. For these securities we will recognize this deferred interest as cash is received. Our cumulative deferred neg am interest is \$4.8 million at December 31, 2006.

### **Commercial CES**

Interest income from our commercial CES was \$25 million in 2006, a \$14 million increase over 2005. This increase is almost entirely the result of higher average balances. We were active buyers of commercial CES in 2006 as we have become more established in this marketplace.

The average yield earned on our commercial CES portfolio in 2006 was 8.73%. The yield was low relative to other CES due to credit loss assumptions. Similar to residential, commercial CES are acquired at a net discount. Commercial CES generally have a ten year maturity and are not expected to receive principal prepayments prior to maturity. As a result, it will take several years to reasonably assess credit performance and recognize any potential upside in yield from discount amortization.

## Interest Income Cash and Cash Equivalents

Interest income from cash and cash equivalents was \$11 million in 2006, a \$6 million increase over 2005. This increase is largely the result of higher average excess cash balances and an increase in yield earned on cash.

## Interest Expense

Interest expense consists of interest payments on Redwood debt, consolidated asset-backed securities (ABS) issued from sponsored securitization entities, and junior subordinated notes. The table below presents our interest income and balances for these components for 2006 and 2005.

55

### TABLE OF CONTENTS

#### Table 23 Total Interest Expense

(Dollars in Thousands)	Year Ended December 31,			
	2006		2005	
Interest expense on consolidated ABS issued	\$ 671,445		\$ 745,477	
Interest expense on Redwood debt	29,836		11,793	
Interest expense on subordinated notes	423			
Total Interest Expense on Total Obligations	\$ 701,704		\$ 757,270	
Average balance of ABS issued	\$ 12,497,551		\$ 20,448,735	
Average balance of Redwood debt	493,357		261,322	
Average balance of subordinated notes	5,336			
Average Total Obligations	\$ 12,996,244		\$ 20,710,057	
Cost of funds of ABS issued	6.05	%	4.51	%
Cost of funds of Redwood debt	5.37	%	3.65	%
Cost of funds of subordinated notes	7.93	%		
Total Cost of Funds of Obligations	5.40	%	3.66	%

Total consolidated interest expense decreased to \$702 million in 2006 from \$757 million in 2005. This was caused by a significant decline in the balance of outstanding consolidated ABS issued in 2006 as a result of rapid prepayments of the loans within these securitization entities. Offsetting much of the decline in balances was the higher cost of funds due to an increase in short-term interest rates as most of our debt and consolidated ABS issued is indexed to one-, three-, or six-month LIBOR. These factors are illustrated in the table below.

#### Table 24 Volume and Rate Changes for Interest Expense

(In Thousands)	Change in Interest Expense Years Ended December 31, 2006 vs. December 31, 2005		
	Volume	Rate	Total Change
Interest expense on ABS	\$ (289,868 )	\$ 215,836	\$ (74,032 )
Interest expense on Redwood debt	10,471	7,572	18,043
Interest expense on subordinated notes	423		423
Total Interest Expense on Total Obligation	\$ (278,974 )	\$ 223,408	\$ (55,566 )

*Volume change is the change in average balance of obligations between periods multiplied by the rate paid in the earlier period. Rate change is the change in rate between periods multiplied by the average outstanding obligations in the current period. Interest expense changes that resulted from changes in both rate and volume were allocated to the rate change amounts shown in the table.*

The table below presents the different components of our interest costs on ABS issued for 2006 and 2005. ABS issuance premiums are created when ABS are issued at prices greater than principal value, such as interest-only (IO) securities.

56

---

TABLE OF CONTENTS

**Table 25 Cost of Funds of Asset-Backed Securities Issued**

(Dollars in Thousands)	Year Ended December 31,			
	2006		2005	
ABS issued interest expense	\$667,061		\$742,542	
ABS issued issuance expense amortization	25,669		21,890	
Net ABS issued interest rate agreement income	(12,472	)	(6,542	)
Net ABS issued issuance premium income amortization	(8,813	)	(12,413	)
Total ABS Issued Interest Expense	\$671,445		\$745,477	
Average balance of ABS issued	\$12,497,551		\$20,448,735	
ABS issued interest expense	5.34	%	3.63	%
ABS issued issuance expense amortization	0.21	%	0.11	%
Net ABS issued interest rate agreement income	(0.10	)%	(0.03	)%
Net ABS issued issuance premium income amortization	(0.07	)%	(0.06	)%
Cost of Funds of ABS Issued	5.38	%	3.65	%

**Operating Expenses**

Total operating expenses increased by 15% in 2006 as compared to 2005. Components of our operating expenses for 2006 and 2005 are presented in the table below.

**Table 26 Operating Expenses**

(In Thousands)	Year Ended December 31,	
	2006	2005
Fixed compensation expense	\$ 13,871	\$ 11,082
Variable compensation expense	19,207	18,558
Systems	7,947	5,666
Due diligence	4,035	2,246
Office costs	4,278	4,076
Accounting and legal	3,533	4,102
Other operating expenses	3,054	2,652
Total Operating Expenses	\$ 55,925	\$ 48,382

Operating expenses increased as we continued to add personnel, systems, and additional internal controls to lay the foundation for future growth. We have expanded our product lines and made significant investments in further developing our business processes and information technology systems.

Fixed compensation expense includes employee salaries and related employee benefits. Fixed compensation expense has increased in 2006 as compared to 2005 due to increased staffing levels. Our headcount increased from 79 at December 31, 2005 to 91 at December 31, 2006. Variable compensation expense includes employee bonuses and the expense of equity awards granted to employees and directors. Employee bonuses are based on the adjusted return on equity earned by Redwood and individual performance.

Due diligence expenses are costs for services related to re-underwriting and analyzing the loans we acquire or the loans we credit-enhance through the purchase of securities. Due diligence expenses increased in 2006 compared to 2005 due to increased commercial CES activity. These costs will fluctuate from period to period, depending on many factors such as the level of asset acquisitions.

Other expenses include custodial fees, excise taxes, training, recruiting, and shareholder relations.

57

---

## TABLE OF CONTENTS

### **Realized Gains on Sales and Calls**

The table below provides a detail of the net realized gains on sales and calls for 2006 and 2005.

#### **Table 27 Realized Gains on Sales and Calls, Net**

(In Thousands)	Year Ended December 31,	
	2006	2005
Realized (losses) gains on sales of:		
Real estate loans	\$ (14 )	\$ 856
Real estate securities	11,205	42,714
Interest rate agreements	8,386	3,160
Gains on sales	19,577	46,730
Gains on calls of residential CES	2,980	19,149
<b>Total Realized Gains on Sales and Calls, Net</b>	<b>\$ 22,557</b>	<b>\$ 65,879</b>

Gains on sales of securities were lower in 2006 compared to 2005, as we sold a significantly higher level of CES in 2005 as part of our portfolio restructuring. Gains on calls were also significantly lower in 2006 compared to 2005 as we had fewer securities called by their issuers in 2006, compared to 2005.

### **Market Valuation Adjustments**

Market valuation adjustments reflect those changes in fair values of assets that we recognize through our income statement. These include write-downs of assets that are impaired under the provisions of EITF 99-20. Impairments are generally caused by an adverse change in projected cash flows in conjunction with a decrease in the fair value. There is no reversal of this impairment on assets, even if projected cash flows improve in the future.

The fair value changes of those interest rate agreements accounted for as trading are also included in valuation adjustment. All changes, whether positive or negative, of these particular interest rate agreements are recognized through the income statement. We use interest rate agreements to manage our interest rate risks, and the changes in the value of the hedged asset or liability is not included in the valuation adjustment. Thus, our use of interest rate agreements accounted for as trading instruments could lead to volatile reported earnings even when they are accomplishing the goal of hedging some of our interest rate risks.

Changes in fair values of our loan purchase commitments are reflected in our income statement. We commit to purchase certain loans and generally do not take possession of the loans for up to a month. During that time, the value of the loan may change from our commitment purchase price and the resulting change in value is recognized through our income statement.

The table below provides the components of market valuation adjustments for 2006 and 2005.

### Table 28 Market Valuation Adjustments, Net

(In Thousands)	Year Ended December 31,	
	2006	2005
Write-downs to fair market value under EITF 99-20	\$(6,831 )	\$(4,370 )
Changes in values of interest rate agreements that are accounted for as trading instruments	(5,731 )	(661 )
Changes in values of purchase commitments	(24 )	
Total Market Value Adjustments, Net	\$(12,586)	\$(5,031 )

### Other Comprehensive Income

Our real estate securities are accounted for as available-for-sale (AFS) and are reported on our consolidated balance sheets at fair value. Many of our derivative instruments are accounted for as cash flow hedges and are also reported on our consolidated balance sheets at fair value. The differences between the value of these assets and our amortized cost are shown as a component of stockholders' equity as accumulated

58

### TABLE OF CONTENTS

other comprehensive income. Periodic changes in the fair value of these assets relative to amortized cost are included in other comprehensive income.

There are a number of factors that affect the fair value of our assets. For most securities and derivative instruments, changes in interest rates can have an impact on the current value. During 2006, the fair value adjustments on AFS assets increased by \$30 million and the fair value adjustments on cash flow hedges decreased by \$10 million.

## Taxes

### Provisions for Income Taxes

Our income tax provision in 2006 was \$10 million, a decrease from the \$18 million income tax provision recorded in 2005, primarily due to a decline in net income.

### Taxable Income and Dividends

During 2006, we earned \$175 million of total taxable income. Of this amount, \$168 million was earned at the REIT and \$7 million was earned at our taxable subsidiaries. Total taxable income is not a measure calculated in accordance with GAAP. It is the pre-tax income calculated for tax purposes. REIT taxable income is an important measure as it is the basis of our required dividend distributions to shareholders. REIT taxable income is that portion of our taxable

income that we earn in our parent (REIT) company and its REIT subsidiaries. It does not include taxable income earned in taxable subsidiaries.

In 2006, we declared four regular quarterly dividends of \$0.70 per share and a special dividend of \$3.00 per share. These dividends completed the distribution of our 2005 REIT taxable income and included the distribution of a part of our 2006 REIT taxable income. All of the 2006 dividends were distributions of ordinary income there were no capital gains distributed and there was no return of capital. At December 31, 2006, there was \$50 million (\$1.89 per share) of 2006 REIT taxable income still undistributed that we distributed to our shareholders during 2007.

The table below reconciles GAAP income to total taxable income for 2006 and 2005.

## Table 29 Differences between GAAP Net Income and Total Taxable Income

(In Thousands, Except Per Share Data)	2006			2005		
	GAAP	Differences	Taxable	GAAP	Differences	Taxable
Interest income	\$885,160	\$(516,142)	\$369,018	\$962,197	\$(749,388)	\$212,809
Interest expense	(701,281)	573,331	(127,950)	(757,270)	721,895	35,375
Subordinated notes	(423 )		(423 )			
Net interest income	183,456	57,189	240,645	204,927	(27,494 )	177,434
Operating expenses	(55,925 )	(8,734 )	(64,659 )	(48,382 )	5,429	(42,953 )
Realized gains on sales and calls	22,557	(20,609 )	1,948	65,879	(11,191 )	54,688
Market valuation adjustments, net	(12,586 )	12,586		(5,031 )	5,031	
Provision for income taxes	(9,970 )	7,090	(2,880 )	(17,521 )	12,278	(5,243 )
Net Income	\$127,532	\$47,522	\$175,054	\$199,872	\$(15,947 )	\$183,925
Shares used for EPS calculations	26,317		25,934	25,121		24,754
Earnings Per Share	\$4.85		\$6.75	\$7.96		\$7.43

Total taxable income per share is computed on a quarterly basis by dividing the estimated pretax total taxable income earned in the calendar quarter by the number of shares outstanding at the end of the quarter. Total taxable income per share for the year is the sum of the four quarters total taxable income per share.

Total taxable income in 2006 of \$175 million (\$6.75 per share) decreased from the \$184 million (\$7.43 per share) earned in 2005. One reason for this decrease was a reduction in gains on sales and calls of assets. For tax purposes, we realized \$2 million of gains in 2006, a decrease from the \$55 million of gains realized in 2005. Another reason was the increase in operating expense in 2006 of \$22 million, which was primarily the result of the timing of the exercise of stock options and the distributions of other equity awards. Operating expenses increased as well due to increases in staffing in 2006.

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### TABLE OF CONTENTS

Partially offsetting the decrease in net gains and the increase in operating expense was a \$63 million increase in net interest income as calculated for tax purposes in 2006. Continued strong credit performance, fast prepayments, and rising short-term interest rates all contributed to increased net yields on our portfolios. For tax purposes, our yields on

our residential, commercial, and CDO CES are higher than for GAAP, primarily due to the difference in timing of amortizing the discount into income. In 2006, we amortized \$30 million more discount into income on our CES portfolios for tax purposes than for GAAP purposes. As a result, at December 31, 2006 the tax basis of our residential, commercial, and CDO CES was \$95 million higher than the GAAP basis.

The other contributor to the increase in net interest income as calculated for tax was tax accounting for IOs. Given the fast prepayments on the underlying loans in 2006, the yield we would currently recognize on these IOs would be negative if accounted for based on economics. For tax purposes, however, we cannot recognize a negative yield, and, thus, we are not amortizing the premium on these IOs as quickly as the fast prepayments would indicate. We are recognizing a zero yield for tax, not a negative yield as would otherwise be indicated. As a result, our taxable income in 2006 was higher by \$25 million than it would have been otherwise (cumulatively the difference is \$56 million). Our taxable income over the next few years will be lower than it would have been otherwise by this same amount. See the discussion of Sequoia IOs under Potential Tax Earnings Volatility above.

60

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TABLE OF CONTENTS

## FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES

### Management's Supplemental Analysis

In the section that follows, we discuss the components of our balance sheet and periodic information we believe will facilitate an understanding of where our capital is invested and an assessment of our investment risk profile. The tables set forth below show the consolidating components of our consolidated balance sheet at December 31, 2007, and our opening balance sheet at January 1, 2008 after giving effect to the adoption of FAS 159. We elected to apply FAS 159 to fair value the assets and liabilities of Acacia and certain other real estate securities held at Redwood. We did not elect to apply FAS 159 to Sequoia assets or liabilities, to most of the securities owned by Redwood, or to our liabilities.

**Table 30 Consolidating Balance Sheet**

December 31, 2007 (In Millions)	Redwood Parent Only	Sequoia	Acacia	Intercompany Adjustments	Redwood Consolidated
Real estate loans	\$4	\$ 7,174	\$26		\$ 7,204
Real estate and other securities	359		1,935	(93 )	2,201
Cash and cash equivalents	290				290
Total earning assets	653	7,174	1,961	(93 )	9,695
Investment in Sequoia	146			(146 )	
Investment in Acacia	(1,385 )			1,385	
Restricted cash	5		113		118
Other assets	62	31	38	(5 )	126
Total Assets	\$(519 )	\$ 7,205	\$2,112	\$ 1,141	\$ 9,939
Redwood debt	\$8	\$	\$	\$	\$ 8
Asset-backed securities issued		7,039	3,383	(93 )	10,329
Other liabilities	41	20	114	(5 )	170
Subordinated notes	150				150

Total liabilities	199	7,059	3,497	(98 )	10,657
Total stockholders equity	(718 )	146	(1,385 )	1,239	(718 )
Total Liabilities and Stockholders Equity	\$ (519 )	\$ 7,205	\$ 2,112	\$ 1,141	\$ 9,939

### Table 31 Consolidating Balance Sheet

January 1, 2008 (In Millions)	Redwood Parent Only	Sequoia	Acacia	Intercompany Adjustments	Redwood Consolidated
Real estate loans	\$ 4	\$ 7,174	\$ 26	\$	\$ 7,204
Real estate and other securities	359		1,935	(93 )	2,201
Cash and cash equivalents	290				290
Total earning assets	653	7,174	1,961	(93 )	9,695
Investment in Sequoia	146			(146 )	
Investment in Acacia	84			(84 )	
Restricted cash	5		113		118
Other assets	62	31	17	(5 )	105
Total Assets	\$ 950	\$ 7,205	\$ 2,091	\$ (328 )	\$ 9,918
Redwood debt	\$ 8	\$	\$	\$	\$ 8
Asset-backed securities issued		7,039	1,893	(93 )	8,839
Other liabilities	41	20	114	(5 )	170
Subordinated notes	150				150
Total liabilities	199	7,059	2,007	(98 )	9,167
Total stockholders equity	751	146	84	(230 )	751
Total Liabilities and Stockholders Equity	\$ 950	\$ 7,205	\$ 2,091	\$ (328 )	\$ 9,918

The following supplemental non-GAAP presentation highlights our financial assets and liabilities by asset type and illustrates the difference between the values used in composition of our GAAP balance sheets and our estimates of economic values. This is the way management assesses our book value.

61

### TABLE OF CONTENTS

In this presentation, we reflect our investments in the securitization entities in separate line items (the equity method) reflecting the reality that the assets and liabilities owned by these entities are not ours and we own only the securities we have acquired from these entities. This table, except for our estimates of economic value, is derived from the Redwood Parent Only balance sheet presented above. This table also illustrates the initial balance sheet impact of a new accounting standard, FAS 159, which we adopted on January 1, 2008.

### Table 32 Components of Book Value

(In Millions, Except Per Share Data)	As Calculated Under GAAP 12/31/07	After Giving Effect to FAS 159 1/1/08	Adjustment	Management's Estimate of Economic Value 12/31/07
Real estate securities (excluding Sequoia and Acacia)				
Residential	\$ 178	\$ 178		\$ 178



Commercial	148	148		148
CDO	33	33		33
Subtotal real estate securities	359	359		359
Cash and cash equivalents	290	290		290
Investment in Sequoia	146	146	(47) <sup>(a)</sup>	99
Investment in Acacia	(1,385 )	84	(38) <sup>(b)</sup>	46
Other assets/liabilities, net <sup>(d)</sup>	22	22		22
Subordinated notes	(150 )	(150 )	56 <sup>(c)</sup>	(94 )
Stockholders Equity	\$ (718 )	\$ 751		\$ 722
Book Value Per Share	\$ (22.18 )	\$ 23.18		\$ 22.29

Our actual Sequoia investments consist of CES, IGS, and IO securities acquired by Redwood from the Sequoia entities. We calculated the \$99 million estimate of economic value for these securities using the same MTM valuation process that we followed to fair value all other real estate securities. In contrast, the \$146 million of GAAP carrying value of these investments represents the difference between residential real estate loans owned by (a) the Sequoia entities and the asset-backed securities (ABS) issued by those entities to third party investors. We account for these loans and ABS issued at cost, not at fair value. GAAP carrying value is \$47 million higher than our estimate of economic value primarily because the accounting method we use to amortize a portion of our loan acquisition premiums has not kept pace with loan prepayments.

Our actual Acacia investments consist of equity interests, and to a lesser extent ABS issued, that we acquired from the Acacia entities. The \$46 million estimate of economic value of our investment interests in the Acacia entities at December 31, 2007 represents the net present value of projected cash flows from our Acacia investments and management fees discounted at 45%. In contrast, the negative \$1.4 billion and \$84 million of GAAP carrying (b) values of our Acacia investments at December 31, 2007 and January 1, 2008, respectively, represent the difference between the securities owned by the Acacia entities and ABS issued by the Acacia entities to third party investors. The reason for the difference between economic and GAAP carrying values is complex and relates to a significant difference in valuation methodology. This difference is discussed in detail in the Mark-to-Market Adjustments Discussion in this document.

We issued \$150 million of 30 year subordinated notes (trust preferred securities or TRUPS) at an interest rate of LIBOR plus 225 basis points. Under GAAP, the TRUPS are carried at cost at both December 31, 2007 and January 1, 2008. Economic value is difficult to estimate with precision as the TRUPS market is currently inactive. We (c) calculated the \$94 million estimate of economic value using the same MTM valuation process used to fair value our other financial liabilities. Estimated economic value is \$56 million lower than our GAAP carrying value because given the significant overall contraction in credit availability and re-pricing of credit risk, if we had issued these subordinated notes at December 31, 2007, investors would have required a substantially higher interest rate.

(d) Other assets/liabilities, net is comprised of real estate loans of \$4 million, restricted cash of \$5 million, and other assets of \$62 million, less Redwood debt of \$8 million and other liabilities of \$41 million.

62

---

### TABLE OF CONTENTS

The table below provides product type and vintage information regarding the \$359 million securities owned by Redwood. This table excludes our investments in Acacia and Sequoia and securities owned by those securitization entities. This table also includes real estate securities acquired in the fourth quarter for the Redwood Opportunity Fund, LP comprised of \$3 million of subprime IGS and \$6 million of CDO IGS from 2004 and prior and \$6 million CDO IGS from 2005.

### **Table 33 Securities at Redwood and Opportunity Fund (Excluding Investments in Sequoia and Acacia)**

December 31, 2007 (In Millions)	2004 & Earlier	2005	2006	2007	Grand Total
Prime					
IGS	\$ 1	\$	\$	\$	\$ 1
CES	73	28	10	16	127
OREI	1				1
Alt-a					
IGS				9	9
CES	3	7	6	7	23
OREI			7	2	9
Subprime					
IGS	4			1	5
CES				1	1
OREI			2		2
Residential Subtotal	82	35	25	36	178
Commercial IGS					
Commercial CES	20	32	69	27	148
CDO IGS	12	12		7	31
CDO CES	1		1		2
Totals	\$ 115	\$ 79	\$ 95	\$ 70	\$ 359

63

### TABLE OF CONTENTS

The following table presents the carrying value (which equals fair value) as a percent of face value for the securities at Redwood and Opportunity Fund (excluding our investments in Sequoia and Acacia).

**Table 34 Fair Value as Percent of Principal Value for Securities at Redwood and Opportunity Fund (Excluding Investments in Sequoia and Acacia)**

(Dollars in Millions)	2004 & Earlier		2005		2006		2007		Total	
	Value	%	Value	%	Value	%	Value	%	Value	%
Prime										
Resi IGS										
AA	\$ 1	100 %	\$		\$		\$		\$ 1	100 %
Resi IGS Total	1	100 %							1	100 %
Resi CES										
BB	27	61 %	15	52 %	3	58 %	5	33 %	50	54 %
B	24	56 %	6	43 %	3	23 %	7	28 %	40	42 %
NR	22	14 %	7	7 %	4	8 %	4	11 %	37	11 %
Resi CES Total	73	30 %	28	20 %	10	15 %	16	21 %	127	24 %
OREI	1								1	
Total Prime	\$ 75	30 %	\$ 28	20 %	\$ 10	15 %	\$ 16	21 %	\$ 129	24 %
Alt-A										
Resi IGS										
AAA	\$		\$		\$		\$ 9	90 %	\$ 9	90 %
Resi IGS Total							9	90 %	9	90 %
Resi CES										

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BB	1	50 %					2	13 %	3	17 %
B			1	44 %	4	24 %	3	9 %	8	15 %
NR	2	8 %	6	13 %	2	5 %	2	4 %	12	7 %
Resi CES Total	3	11 %	7	14 %	6	10 %	7	7 %	23	10 %
OREI					7	3 %	2	1 %	9	2 %
Total Alt-A	\$ 3	11 %	\$ 7	14 %	\$ 13	22 %	\$ 18	16 %	\$ 41	17 %
Subprime										
Resi IGS										
A	\$ 3	75 %	\$		\$		\$		\$ 3	75 %
BBB	1	63 %					1	8 %	2	15 %
Resi IGS Total	4	63 %					1	8 %	5	15 %
Resi CES										
C							1	6 %	1	5 %
Resi CES Total							1	6 %	1	5 %
OREI					2	20 %			2	20 %
Total Subprime	\$ 4	57 %	\$		\$ 2	100 %	\$ 2	6 %	\$ 8	18 %
CDO										
CDO IGS										
AAA	\$ 6	43 %	\$ 6	30 %	\$		\$ 6	24 %	\$ 18	31 %
AA	6	46 %	6	17 %					12	25 %
BBB							1	33 %	1	33 %
CDO IGS Total	12	44 %	12	22 %			7	25 %	31	28 %
CDO CES										
BB	1	36 %							1	25 %
NR					1	13 %			1	13 %
CDO CES Total	1	36 %			1	9 %			2	7 %
Total CDO	\$ 13	39 %	\$ 12	22 %	\$ 1	9 %	\$ 7	25 %	\$ 33	24 %
CMBS										
Comm CES										
BB	\$ 7	78 %	\$		\$ 11	48 %	\$ 8	50 %	\$ 26	55 %
B					13	37 %	11	41 %	24	38 %
NR	13	27 %	32	26 %	45	22 %	8	22 %	98	24 %
Comm CES Total	20	35 %	32	26 %	69	26 %	27	34 %	148	28 %
Total CMBS	\$ 20	35 %	\$ 32	26 %	\$ 69	26 %	\$ 27	34 %	\$ 148	28 %

64

TABLE OF CONTENTS

The following table presents the components of carrying value (which equals fair value) for residential and commercial CES (excluding our investments in Sequoia and Acacia).

**Table 35 Credit-Enhancement Securities at Redwood**

December 31, 2007 (In Millions)	Residential		
	Prime	Alt-a	Commercial
Current face	\$ 528	\$ 235	\$ 522
Unamortized discount, net	(76 )	(14 )	(18 )
Discount designated as credit reserve	(288 )	(195 )	(318 )
Amortized cost	164	26	186

Table 34 Fair Value as Percent of Principal Value for Securities at Redwood and Opportunity Fund (Excluding Inves

Gross unrealized market value gains	11		5
Gross unrealized market value losses	(48 )	(3 )	(43 )
Carrying Value	\$ 127	\$ 23	\$ 148
Carrying value as a percentage of face	24 %	10 %	28 %

We estimate that our overall investments in Acacia entities had an economic value at December 31, 2007 of \$46 million based on the net present value of projected cash flows from our investment interests and management fees discounted at 45%. The table below presents the assets owned by each Acacia entity, by product type, and the corresponding liabilities as reported on January 1, 2008 after the adoption of FAS 159.

**Table 36 Acacia Balance Sheets**

January 1, 2008 (In Millions)	Acacia 5 Issued Jul-04	Acacia 6 Issued Nov-04	Acacia 7 Issued Mar-05	Acacia 8 Issued Jul-05	Acacia CRE1 9 Issued Dec-05	Acacia 10 Issued Mar-06	Acacia 11 Issued Aug-06	Acacia 12 Issued Feb-07	Acacia OA1 12 Issued May-07	Acacia 12 Issued Jun-07	Total
Residential IGS											
Prime Sequoia	\$ 12	\$ 14	\$ 10	\$ 5	\$ 1	\$ 3	\$ 4	\$ 3	\$ 8	\$ 15	\$ 75
Prime Other	37	54	64	60	36	97	90	38	7	31	514
Alt-a	23	15	17	17	3	13	38	87	93	111	417
Subprime	45	74	53	4		8	3	9	1	14	211
Residential CES											
Prime Sequoia	2	4	3	5		2	2				18
Prime Other	22	18	12	33		17	67	16		9	194
Alt-a	1	2	2	11		3	3	16	8	2	48
Subprime	1			2			2	3		1	9
Commercial IGS	7	11	6	9	50	3	1			3	90
Commercial CES	1	4	12	20	74	14	25	23		16	189
Commercial Loans	4		9	4	9						26
CDO: CMBS	2	1	2		12	7	7	13	4	7	55
CDO: RMBS	7	5	5	3		2	2	7		5	36
GIC									79		79
Totals	164	202	195	173	185	169	244	215	200	214	1,961
Restricted cash and other assets	16	13	29	20	6	9	9	7	12	9	130
Total Assets	\$ 180	\$ 215	\$ 224	\$ 193	\$ 191	\$ 178	\$ 253	\$ 222	\$ 212	\$ 223	\$ 2,091
ABS issued and other liabilities	\$ 173	\$ 230	\$ 217	\$ 202	\$ 151	\$ 204	\$ 234	\$ 234	\$ 173	\$ 189	\$ 2,007
Total Equity	7	(15 )	7	(9 )	40	(26 )	19	(12 )	39	34	84
Total Liabilities and Equity	\$ 180	\$ 215	\$ 224	\$ 193	\$ 191	\$ 178	\$ 253	\$ 222	\$ 212	\$ 223	\$ 2,091

65

TABLE OF CONTENTS

The following table presents the carrying value (which equals fair value) as a percent of face value for the securities at Acacia.

**Table 37 Fair Value as Percent of Principal Value for Securities at Acacia**

(Dollar in Millions)	2004 & Earlier		2005		2006		2007		Total	
	Value	%	Value	%	Value	%	Value	%	Value	%
<b>Prime</b>										
Resi IGS										
AAA	\$ 9	96 %	\$ 15	94 %	\$ 7	94 %	\$		\$ 31	97 %
AA	58	89 %	58	73 %	28	70 %	7	64 %	151	77 %
A	48	84 %	83	65 %	33	59 %	8	53 %	172	67 %
BBB	28	78 %	82	56 %	24	45 %	26	44 %	160	54 %
Resi IGS Total	143	86 %	238	65 %	92	59 %	41	48 %	514	66 %
Resi CES										
BB	74	61 %	52	51 %	27	31 %	5	42 %	158	49 %
B	7	70 %	17	35 %	11	28 %			35	36 %
NR					1	33 %			1	33 %
Resi CES Total	81	62 %	69	46 %	39	30 %	5	42 %	194	46 %
Total Prime	\$ 224	75 %	\$ 307	59 %	\$ 131	46 %	\$ 46	47 %	\$ 708	59 %
<b>Alt-A</b>										
Resi IGS										
AAA	\$ 10	83 %	\$ 4	80 %	\$ 117	92 %	\$ 73	89 %	\$ 204	91 %
AA	14	88 %	7	58 %	30	58 %	17	49 %	68	59 %
A	6	75 %			40	28 %	41	29 %	87	30 %
BBB	4	71 %	9	36 %	28	23 %	17	20 %	58	24 %
Resi IGS Total	34	81 %	20	48 %	215	48 %	148	43 %	417	48 %
Resi CES										
BB	14	47 %	6	30 %	16	22 %	7	15 %	43	25 %
B	1			13 %	4	11 %			5	11 %
NR										
Resi CES Total	15	45 %	6	25 %	20	19 %	7	14 %	48	22 %
Total Alt-A	\$ 49	67 %	\$ 26	39 %	\$ 235	42 %	\$ 155	40 %	\$ 465	43 %
<b>Subprime</b>										
Resi IGS										
AAA	\$		\$ 4	80 %	\$ 2	56 %	\$ 9	90 %	\$ 15	83 %
AA	37	76 %	42	85 %	7	50 %	4	33 %	90	73 %
A	50	75 %	13	48 %	1	14 %			64	61 %
BBB	36	63 %			2	13 %	4	11 %	42	46 %
Resi IGS Total	123	75 %	59	72 %	12	31 %	17	30 %	211	62 %
Resi CES										
BB							1	6 %	1	6 %
B					5	14 %			5	13 %
NR					3	6 %			3	6 %
Resi CES Total					8	8 %	1		9	7 %
Total Subprime	\$ 123	75 %	\$ 59	72 %	\$ 20	51 %	\$ 18	28 %	\$ 220	49 %
<b>CDO</b>										
CDO IGS										
AAA	\$ 6	75 %	\$ 7	50 %	\$ 1	11 %	\$ 3	17 %	\$ 17	36 %
AA	8	44 %	1				2	67 %	11	42 %
A	17	50 %	3	27 %	3	30 %			23	38 %
BBB	14	54 %	3	27 %	12	39 %	3	33 %	32	42 %

CDO	IGS Total	45	52 %	14	35 %	16	32 %	8	22 %	83	39 %
CDO	CES										
BB		1	13 %	5	50 %	1	33 %			7	33 %
B						1	10 %			1	9 %
CDO	CES Total	1	11 %	5	50 %	2	8 %			8	17 %
Total CDO		\$46	49 %	\$19	38 %	\$18	23 %	\$8	21 %	\$91	35 %
CMBS											
Comm	IGS										
AAA		\$		\$9	95 %	\$2	98 %	\$		\$11	95 %
AA		1	77 %							1	77 %
A		15	88 %	3	75 %					18	82 %
BBB		22	84 %	36	74 %	2	100 %			60	77 %
Comm	IGS Total	38	84 %	48	77 %	4	100 %			90	80 %
Comm	CES										
BB		24	57 %	47	59 %	61	55 %	4	44 %	136	56 %
B		6	50 %	17	49 %	30	44 %			53	46 %
Comm	CES Total	30	56 %	64	56 %	91	51 %	4	44 %	189	53 %
Total CMBS		\$68	68 %	\$112	63 %	\$95	52 %	\$4	44 %	\$279	60 %

66

## TABLE OF CONTENTS

### Summary

The following is a discussion of our business of investing in, financing, and managing real estate loans and securities by type of earning asset consolidated on our balance sheet.

### Residential Real Estate Loans

We acquire high-quality residential real estate loans on a bulk or flow basis from originators. Prior to 2006, these loan purchases were predominately comprised of short reset LIBOR indexed ARMs (LIBOR ARMs). Since then, we have expanded our residential conduit s product offerings to include high-quality hybrid loans (loans with a fixed-rate coupon for a period of two to ten years before becoming adjustable). All of the \$1.2 billion of loans acquired during the year ended December 31, 2007 were hybrid loans.

The following table provides details of the activity with respect to our residential real estate loans for 2007 and 2006.

### Table 38 Residential Real Estate Loans Activity

(In Thousands)	2007	2006
Balance at beginning of period	\$9,323,935	\$13,874,792
Acquisitions	1,170,961	2,017,686
Sale proceeds	(15,454 )	
Principal repayments	(3,228,093)	(6,513,348 )
Transfers to real estate owned	(24,940 )	(6,889 )
Market valuation adjustments	196	
Premium amortization	(37,671 )	(48,700 )
Provision for credit losses	(10,461 )	394

Balance At End of Period \$7,178,473    \$9,323,935

Our residential real estate loan balance declined to \$7.2 billion at December 31, 2007 from \$9.3 billion at December 31, 2006. Of the balance at December 31, 2007, 68% (by unpaid principal balance) of the loans were one and six-month LIBOR ARMs, and almost entirely were financed via securitization (only \$5 million was funded with equity).

## Residential Credit-Enhancement Securities

The largest part of our business in terms of capital employed is investing in residential CES. These credit-enhancement securities have credit ratings that are below investment-grade and have both the upside opportunities and downside risks that come from taking on concentrated credit risks.

Our residential CES portfolio had a fair value of \$402 million at December 31, 2007 and \$722 million at December 31, 2006. As a result of the concentrated credit risk associated with residential loan CES, we are generally able to acquire these securities at a discount to their face (principal) value. At December 31, 2007, the difference between the principal value (\$1.5 billion) and carrying value (\$402 million) which equals fair value of these residential loan CES was \$1.1 billion. Of this difference, \$677 million was designated as internal credit reserve (reflecting our estimate of credit losses on the underlying loans over the life of these securities), \$317 million represented unamortized discount we are accreting into income over time, and \$143 million represented net unrealized mark-to-market losses. Amortized cost (principal value less internal credit reserve less amortized discount) decreased \$119 million from \$664 million at December 31, 2006 to \$545 million at December 31, 2007 as acquisitions, discount amortization, and transfers of securities from other portfolios exceeded pay-downs and sales. Net unrealized mark-to-market gains fell by \$201 million from gains of \$58 million at December 31, 2006 to losses of \$143 million at December 31, 2007.

The following table provides detail of the activity with respect to our residential CES for 2007 and 2006.

67

### TABLE OF CONTENTS

#### Table 39 Residential CES Activity

(In Thousands)	2007	2006
Balance at beginning of period	\$ 721,531	\$ 592,552
Acquisitions	178,033	250,214
Sales	(8,506 )	(62,232 )
Realized gains on sales, net	252	6,970
Principal repayments (including calls)	(152,374 )	(98,886 )
Realized gains on calls, net	5,080	1,341
Discount amortization	75,543	57,404
Transfer to (from) other portfolios	100,644	(30,667 )
Changes in fair value, net	(518,258 )	4,835
Balance At End of Period	\$ 401,945	\$ 721,531

The \$178 million residential CES acquired in 2007 was comprised of \$123 million prime securities, \$51 million alt-a securities, and \$4 million subprime securities.

During 2007, we had a net transfer of \$112 million of IGS to our CES portfolio as a result of rating downgrades by the credit rating agencies and \$11 million was transferred out in the first quarter of 2007 to the other real estate

investment portfolio. Prior to the second half of 2007, we had a net transfer of securities from CES to IGS as ratings improved on some securities. However in the second half of 2007, a significant number of securities were downgraded. We expect more downgrades in 2008.

The following table details our residential CES portfolios by the underlying loan type (prime, alt-a, subprime) and by current credit rating at December 31, 2007 and 2006.

**Table 40 Residential CES Credit Rating and Collateral Type**

December 31, 2007 (In Millions)	Rating			Total
	BB	B	Unrated	
Prime	\$ 208	\$ 75	\$ 38	\$ 321
Alt-a	46	13	12	71
Subprime	1	5	4	10
Total Residential CES	\$ 255	\$ 93	\$ 54	\$ 402

December 31, 2006 (In Millions)	Rating			Total
	BB	B	Unrated	
Prime	\$ 307	\$ 119	\$ 129	\$ 555
Alt-a	94	23	40	157
Subprime	7		3	10
Total Residential CES	\$ 408	\$ 142	\$ 172	\$ 722

Prime securities are residential mortgage-backed securities backed primarily by high credit quality loans. Many of the loans are jumbos, with loan balances greater than existing conforming loan limits. Prime securities typically have relatively high weighted average FICO scores (700 or higher), low (75% or less), weighted average loan-to-value ratios (LTV), and limited concentrations of investor properties.

Alt-a securities are residential mortgage-backed securities that have higher credit quality than subprime and lower credit quality than prime. Alt-a originally represented loans with alternative documentation, but has shifted over time to include loans with additional risk characteristics and a higher percentage of investor loans. Borrower's income may not be verified, and in some cases, may not be disclosed on the loan application. Expanded criteria also allows for higher debt-to-income ratios with higher accompanying LTV than otherwise would be permissible for prime loans.

Subprime securities are residential mortgage-backed securities backed by loans to borrowers who have impaired credit histories, but who appear to exhibit the ability to repay the current loan. Typically, these

68

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TABLE OF CONTENTS

borrowers have lower credit scores or other credit deficiencies that prevent them from qualifying for prime or alt-a mortgages. To compensate for the greater risks and higher costs to service these loans, subprime borrowers pay higher interest rates, points, and origination fees. When evaluating the acquisition of CES backed by subprime loans, we use loss assumptions that are significantly higher than those we use for prime loans.

The following table details our residential CES portfolios by the product type and collateral vintage at December 31, 2007.



**Table 41 Residential CES Product and Vintage**

December 31, 2007 (In Millions)	Vintage 2004 & Earlier	2005	2006	2007	Total
Prime					
Option ARM	\$ 26	\$ 46	\$ 11	\$ 2	\$ 85
ARM	29	4			33
Hybrid	73	38	29	10	150
Fixed	26	9	9	9	53
Total Prime	154	97	49	21	321
Alt-a					
Option ARM	15	13	26	13	67
ARM	1				1
Hybrid	2				2
Fixed				1	1
Total Alt-a	18	13	26	14	71
Subprime					
Hybrid			3	1	4
Fixed			5	1	6
Total subprime			8	2	10
Total Residential CES	\$ 172	\$ 110	\$ 83	\$ 37	\$ 402

The loans underlying all of our residential CES totaled \$250 billion (by unpaid principal balance) at December 31, 2007, and consist of \$196 billion prime, \$31 billion alt-a, and \$23 billion subprime. These loans are located nationwide with a large concentration in California (46%). During 2007, realized residential credit losses were \$26 million of principal value, a rate that equals one basis point (0.01%) on an annualized basis of the balance of loans. Serious delinquencies (90+ days, in foreclosure or REO) at December 31, 2007 were 2.99% of current balance and 1.68% of original balance. For loans in prime pools, delinquencies were 0.71% of current balance and 0.38% of original balance. Alt-a loan pools had delinquencies of 6.49% of current balance and 3.72% of original balance.

Subprime loans had delinquencies of 17.80% of current balance and 14.24% of original balance.

**Residential Investment-Grade Securities**

We invest in investment-grade residential securities (IGS) backed by prime, alt-a, and subprime residential loans. Our residential investment-grade securities totaled \$1.2 billion at December 31, 2007 and \$1.7 billion at December 31, 2006. The decrease in our balance resulted from the decrease in market values of \$909 million of the securities as our acquisitions exceeded our sales, pay-downs, and transfers to other portfolios. The majority of these securities are funded through securitizations under our Acacia program. These IGS are not directly exposed to first-loss credit risk as they benefit from credit-enhancement provided by others' securities.

The following table provides detail of the activity for our residential IGS for 2007 and 2006.

**Table 42 Residential IGS Activity**

(In Thousands)	2007	2006
Balance at beginning of period	\$1,697,250	\$1,260,090
Acquisitions	1,003,787	732,692
Sales	(361,007 )	(218,219 )
Realized (losses) gains on sales, net	(5,350 )	2,155
Principal repayments (including calls)	(157,306 )	(117,976 )
Realized gains on calls, net	324	65
Discount amortization	7,428	5,265
Transfer (to) from other portfolios	(118,940 )	30,667
Changes in fair value, net	(908,722 )	2,511
Balance At End of Period	\$1,157,464	\$1,697,250

The \$1.0 billion of IGS acquired in 2007 consisted of \$306 million prime, \$511 million alt-a, and \$187 million subprime. The majority of these securities were acquired in the first half of 2007 for our Acacia program as we completed three CDOs by the third quarter of 2007. The transfers to other portfolios were mainly the result of downgrades from the rating agencies and \$112 million of these securities are now reported in residential CES. The remaining \$7 million was transferred in the first quarter of 2007 to the other real estate investment portfolio. Consistent with the whole mortgage industry in 2007 spreads significantly widened on our residential IGS causing prices and fair values to fall considerably. Of the \$909 million decrease in fair value, \$820 million was experienced in the second half of the year.

The following table details the type of underlying loans (prime, alt-a, subprime) and the current credit rating of our residential IGS as of December 31, 2007 and 2006.

**Table 43 Residential IGS Credit Rating and Collateral Type**

December 31, 2007 (In Millions)	Rating				Total
	AAA	AA	A	BBB	
Prime	\$ 31	\$ 152	\$ 172	\$ 160	\$ 515
Alt-a	213	68	87	58	426
Subprime	15	90	67	44	216
Total Residential IGS	\$ 259	\$ 310	\$ 326	\$ 262	\$ 1,157

December 31, 2006 (In Millions)	Rating				Total
	AAA	AA	A	BBB	
Prime	\$ 14	\$ 181	\$ 243	\$ 285	\$ 723
Alt-a	136	84	106	130	456
Subprime	8	127	209	174	518
Total Residential IGS	\$ 158	\$ 392	\$ 558	\$ 589	\$ 1,697

70

**TABLE OF CONTENTS**

The following table details our residential IGS portfolio by the product type and collateral vintage at December 31, 2007.

**Table 44 Residential IGS Product and Vintage**

December 31, 2007 (In Millions)	Vintage 2004 & Earlier	2005	2006	2007	Total
Prime					
Option ARM	\$ 25	\$ 126	\$ 36	\$ 10	\$ 197
ARM	25	10	2		37
Hybrid	68	92	32	10	202
Fixed	26	10	22	21	79
Total prime	144	238	92	41	515
Alt-a					
Option ARM	17	16	81	64	178
ARM	3				3
Hybrid	8	4	31	33	76
Fixed	6		103	60	169
Total Alt-a	34	20	215	157	426
Subprime					
ARM	1			5	6
Hybrid	90	45	5	10	150
Fixed	36	14	7	3	60
Total subprime	127	59	12	18	216
Total Residential IGS	\$ 305	\$ 317	\$ 319	\$ 216	\$ 1,157

The following table details the vintage of the underlying loan collateral behind our subprime IGS at December 31, 2007.

**Table 45 Subprime IGS Credit Rating and Collateral Vintage**

December 31, 2007 (In Millions)	Vintage 2004 & Earlier	2005	2006	2007	Total
IGS					
AAA	\$	\$ 4	\$ 2	\$ 9	\$ 15
AA	37	42	7	4	90
A	53	13	1		67
BBB+	29		1	3	33
BBB	1		1	1	3
BBB-	7			1	8
Total IGS	\$ 127	\$ 59	\$ 12	\$ 18	\$ 216

**Commercial Real Estate Loans**

We have invested in commercial real estate loans since 1998. At December 31, 2007 and 2006, commercial real estate loans totaled \$26 million and \$28 million, respectively. These include mezzanine loans, subordinated (junior or senior lien) loans, and b-notes (b-notes represent a structured commercial real estate loan that retains a higher portion of the credit risk and generates a higher yield than the initial loan). Except for one loan (where we are fully reserved for an anticipated loss on a junior mezzanine loan financing a condominium-conversion project), credit performance of our commercial loan portfolio remains strong and in line with our expectations.

The following table provides activity on our commercial real estate loans for 2007 and 2006.

71

---

TABLE OF CONTENTS

**Table 46 Commercial Real Estate Loans Activity**

(In Thousands)	2007	2006
Balance at beginning of period	\$ 28,172	\$ 59,692
Sales		(8,408 )
Realized gains on sales, net		(14 )
Principal repayments	(245 )	(23,231 )
Discount amortization	99	168
Provision for credit losses	(2,348 )	(35 )
Balance At End of Period	\$ 25,678	\$ 28,172

**Commercial Credit-Enhancement Securities**

Our total commercial CES was \$337 million at December 31, 2007, a decrease from \$448 million at December 31, 2006 due primarily to a decrease in fair value. At December 31, 2007, these securities provided credit-enhancement on \$62 billion underlying loans on office, retail, multifamily, industrial, and other income-producing properties nationwide.

The following table provides detail of the activity on our commercial CES for 2007 and 2006.

**Table 47 Commercial CES Activity**

(In Thousands)	2007	2006
Balance at beginning of period	\$ 448,060	\$ 218,856
Acquisitions	51,920	238,669
Sales	(2,945 )	(16,950 )
Realized (losses) gains on sales, net	(600 )	352
Principal repayments (including calls)		(41 )
Discount amortization	271	(1,561 )
Transfer to other portfolios	(3,501 )	(3,966 )
Changes in fair value, net	(156,370 )	12,701
Balance At End of Period	\$ 336,835	\$ 448,060

The \$52 million of commercial CES was acquired in the first half of 2007. Due to widening spreads and falling prices on commercial assets the CES fell \$156 million in value of which \$110 million occurred in the second half of 2007.

The following table presents the current credit ratings of our commercial CES at December 31, 2007 and 2006.

**Table 48 Commercial CES Credit Rating**

(In Millions)	Rating			Total
	BB	B	Unrated	

December 31, 2007	\$ 162	\$ 77	\$ 98	\$ 337
December 31, 2006	\$ 224	\$ 90	\$ 134	\$ 448

As a result of the concentrated credit risk associated with commercial CES, we are generally able to acquire these securities at a discount to their face (principal) value. The difference between the principal value (\$876 million) and carrying value (\$337 million) of our commercial CES at December 31, 2007 was \$539 million. Of this difference, \$318 million was designated as internal credit reserve (reflecting our estimate of likely credit losses on the underlying loans over the life of these securities), \$96 million represented unamortized discount we are accreting into income over time, and \$125 million represented net unrealized mark-to-market losses.

Seriously delinquent loans underlying commercial CES were \$183 million, an increase of \$2 million from the beginning of the year. The majority of the increase is concentrated in one \$81 million loan. Property

72

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### TABLE OF CONTENTS

fundamentals of the collateral property for this loan remain adequate and based upon the property's income and in-place reserves; we do not anticipate a loss on this loan at this time. Of the net remaining \$102 million in serious delinquencies, \$48 million are contained within one security that we deemed impaired during a prior period. Despite the increase in total serious delinquencies, our loss expectations have not increased incrementally. We consider our credit reserve of \$318 million to be appropriate as of December 31, 2007.

## **Commercial Investment-Grade Securities**

Our commercial IGS totaled \$89 million at December 31, 2007 and \$120 million at December 31, 2006. Our balance of commercial IGS has generally been declining over the last several quarters, as we have slowed acquisitions of commercial IGS.

The following table provides detail of the activity for commercial CES for 2007 and 2006.

### **Table 49 Commercial IGS Activity**

(In Thousands)	2007	2006
Balance at beginning of period	\$ 119,613	\$ 185,032
Acquisitions	4,954	11,172
Sales	(8,061 )	(75,508 )
Realized (losses) gains on sales, net	(449 )	1,380
Principal repayments (including calls)	(9,700 )	(7,624 )
Discount amortization	270	(212 )
Transfer from other portfolios	3,501	3,966
Changes in fair value, net	(20,452 )	1,407
Balance At End of Period	\$ 89,676	\$ 119,613

The following table presents the current credit ratings of our commercial IGS at December 31, 2007 and 2006.

### **Table 50 Commercial IGS Credit Rating**

(In Millions)	Rating				Total
	AAA	AA	A	BBB	

December 31, 2007	\$ 11	\$ 1	\$ 18	\$ 60	\$ 90
December 31, 2006	\$ 9	\$ 2	\$ 16	\$ 93	\$ 120

### CDO Credit-Enhancement Securities

CDOs are a form of securitization in which a diverse portfolio of assets is acquired by a securitization entity that creates and sells securities (CDO securities) in order to fund its asset purchases. We acquire CDO securities created by others that are generally backed by residential and commercial real estate assets and are generally financed through our Acacia securitizations.

At December 31, 2007, our CDO CES totaled \$10 million, a decrease from \$22 million at December 31, 2006. The change in balance consisted of \$5 million in acquisitions, \$2 million in principal repayments, \$18 million in net transfers from CDO IGS, and a negative \$33 million change in fair value recognized through other comprehensive (loss) income.

73

### TABLE OF CONTENTS

The following tables present the credit ratings of our CDO CES at December 31, 2007 and 2006.

#### Table 51 CDO CES Credit Rating

(In Millions)	Rating			Total
	BB	B	Unrated	
December 31, 2007	\$ 8	\$ 1	\$ 1	\$ 10
December 31, 2006	\$ 14	\$	\$ 8	\$ 22

### CDO Investment-Grade Securities

At December 31, 2007, our CDO IGS totaled \$114 million, a decrease of \$110 million from the December 31, 2006 balance of \$224 million. During 2007, acquisitions of CDO investment-grade securities were \$83 million, principal payments were \$9 million, net transfers to CDO CES were \$18 million, and mark-to-market adjustments were negative \$166 million.

The following table presents the credit ratings of our CDO IGS at December 31, 2007 and 2006.

#### Table 52 CDO IGS Credit Rating

(In Millions)	Rating				Total
	AAA	AA	A	BBB	
December 31, 2007	\$ 35	\$ 23	\$ 23	\$ 33	\$ 114
December 31, 2006	\$ 66	\$ 30	\$ 52	\$ 76	\$ 224

### Other Real Estate Investments

Our other real estate investments totaled \$12 million at December 31, 2007. There were no assets classified as other real estate investments at December 31, 2006.

The following table represents the activity within other real estate investments during 2007.

**Table 53 Other Real Estate Investment Activity**

(In Thousands)	2007
Balance at beginning of period	\$
Acquisitions	40,790
Sales	(2,237 )
Principal repayments (including calls)	(15,686 )
Discount amortization	(5,955 )
Transfer from other portfolios	18,296
Changes in fair value, net	(23,687 )
Balance At End of Period	\$ 11,521

Acquisitions during 2007 were \$41 million, which consisted of \$21 million of alt-a securities and \$20 million of subprime securities. Of the \$24 million of negative fair value change in other real estate investments for 2007, \$5 million related to investments acquired prior to this year, which were reclassified into this portfolio in the first quarter of 2007.

74

**TABLE OF CONTENTS**

The following table presents the current credit ratings of our other real estate investments at December 31, 2007.

**Table 54 Other Real Estate Investments Credit Rating**

	Rating							
(In Millions)	AAA	AA	A	BBB	BB	B	Unrated	Total
December 31, 2007	\$ 1	\$	\$ 1	\$ 2	\$ 2	\$ 3	\$ 3	\$ 12

**Liabilities and Stockholders Equity****Redwood Debt**

During 2007, we used repurchase (repo) agreements and our Madrona commercial paper facility to temporarily finance certain of our residential real estate loans which we then securitized. We also used warehouses and repo agreements to finance securities. The warehouses had limited recourse to Redwood, whereas other Redwood debt facilities have full recourse to us. Redwood debt is secured by pledges of our loans and securities. The table below shows the amount of debt outstanding by facility at December 31, 2007 and 2006.

**Table 55 Redwood Debt by Facility**

(In Thousands)	2007	2006
Loans		
Repo agreements	\$	\$ 959,139
Madrona commercial paper facility		300,000
Securities		
Repo agreements	7,561	
Acacia warehouses		597,069

Total Redwood Debt \$ 7,561      \$ 1,856,208

Due to the decline in mortgage market economic conditions during the second half of 2007 we determined that we did not need the same level of available Redwood debt facilities as we had at the end of 2006. Therefore, we have not renewed the majority of our facilities that expired in the fourth quarter of 2007. At December 31, 2007 we had no commercial paper outstanding as we had closed our Madrona facility in December, 2007 and we accelerated the amortization of \$0.6 million of deferred costs in the fourth quarter. At December 31, 2006, we had \$300 million of commercial paper outstanding through our Madrona special purpose entity.

## Asset-Backed Securities Issued

Redwood, through its sponsored securitization entities, has securitized the majority of the assets shown on its consolidated balance sheets. These securitization entities acquire assets and create and sell asset-backed securities (ABS) in order to fund their asset purchases. The residential whole loan securitization entities Redwood sponsors are called Sequoia and the CDO securitization entities Redwood sponsors are called Acacia. These securitization entities are bankruptcy-remote from Redwood, so that Redwood's liabilities cannot become liabilities of the securitization entity and the ABS issued by the securitization entity cannot become obligations of Redwood. Nevertheless, since, according to accounting definitions, we control these securitization entities, we show both the assets and liabilities of these entities on our consolidated balance sheets. At December 31, 2007, our consolidated balance sheets included \$9.2 billion of assets (a combination of securities at fair value and loans at amortized cost) owned by the securitization entities (92% of total consolidated assets) and included \$10.4 billion of liabilities (all at amortized cost) issued by securitization entities (97% of total consolidated liabilities). As the majority of the assets (the securities) within Acacia are recorded at current fair values but the Acacia liabilities are recorded at cost, the decline in fair values during 2007 produced a negative equity position where liabilities exceed assets on our consolidated financial statements.

75

### TABLE OF CONTENTS

The following table provides detail of the activity for asset-backed securities for 2007 and 2006.

#### Table 56 ABS Issued Activity

2007 (In Thousands)	December 31, 2006	New Issuance	Paydowns	(Gain) on ABS Payoff	Amortization	December 31, 2007
Sequoia ABS issued with principal value, net	\$7,595,003	\$2,798,011	\$(3,471,289)	\$	\$(10,755)	\$6,910,970
Sequoia ABS interest only issued	74,548				(39,328)	35,220
Acacia issued ABS with principal value, net	2,294,629	1,417,597	(340,718)	(12,500)	374	3,359,382
Acacia ABS CES issued	15,044	6,470			2,193	23,707
<b>Total ABS Issued</b>	<b>\$9,979,224</b>	<b>\$4,222,078</b>	<b>\$(3,812,007)</b>	<b>\$(12,500)</b>	<b>\$(47,516)</b>	<b>\$10,329,279</b>
2006 (In Thousands)	December 31, 2005	New Issuance	Paydowns	(Gain) on ABS Payoff	Amortization	December 31, 2006



Sequoia ABS issued with principal value, net	\$13,274,192	\$799,048	\$(6,468,345)	\$	\$(9,892)	\$7,595,003
Sequoia ABS interest only issued	142,788				(68,240)	74,548
Acacia issued ABS with principal value, net	2,164,063	682,801	(552,636)	)	401	2,294,629
Acacia ABS CES issued		14,367			677	15,044
Commercial	4,234		(4,251)	)	17	
Total ABS Issued	\$15,585,277	\$1,496,216	\$(7,025,232)	\$	\$(77,037)	\$9,979,224

Generally, when we securitize assets, as opposed to owning them directly and funding them with Redwood debt and equity, our reported cost of funds is higher (the cost of ABS securities issued is generally higher than that of our debt) but we utilize less equity capital. As a result, our return on equity may increase after securitization. In addition, liquidity risks are generally reduced or eliminated, as the Redwood debt associated with the accumulation of these assets during their accumulation is paid off upon securitization.

## Subordinated Notes

In 2006, we issued \$100 million of subordinated notes (trust preferred securities) through Redwood Capital Trust I, a wholly-owned Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than January 30, 2037. The earliest optional redemption date without a penalty is January 30, 2012.

In May 2007, we issued \$50 million of subordinated notes which require quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than July 30, 2037. The earliest optional redemption date without a penalty is July 30, 2012.

In our internal risk-adjusted capital calculations we include these subordinated notes in our capital base.

## Derivative Financial Instruments

We currently have three kinds of derivative instruments; interest rate agreements, commitments to purchase, and credit default swaps. All derivatives are reported on our balance sheet at fair value. Changes in the fair values of derivatives are either recorded through our consolidated statements of income (loss) or through accumulated other comprehensive income (loss) on our consolidated balance sheets.

We enter into interest rate agreements to help manage some of our interest rate risks. We enter into these agreements with highly rated counterparties and maintain certain risk management policies limiting our exposure concentrations to any counterparty. At December 31, 2007, we were party to interest rate agreements with an aggregate notional value of \$3.1 billion and a net negative fair value of \$76 million. At December 31, 2006, we were party to interest rate agreements with an aggregate notional value of \$3.0 billion and a net positive fair value of \$21 million.

At December 31, 2007, we had no outstanding commitments to purchase residential real estate loans. At December 31, 2006, we had commitments to purchase \$81 million residential real estate loans with an estimated value of negative \$0.2 million. Purchase commitments have zero value at the date of the commitment so any subsequent changes in value are recognized through our income statements. Once the loans are purchased, the value of the purchase commitment adjusts our cost basis in the loans.

TABLE OF CONTENTS

We entered into our first credit default swaps in the first quarter of 2007. At December 31, 2007 we had a \$79 million notional balance worth negative \$57 million. The swaps have zero value at purchase, so the entire decrease in value was recognized through our income statement during 2007.

**Stockholders Equity**

Our reported book value at December 31, 2007 was negative \$22.18 per share, a decrease from \$37.51 per share at the beginning of the year. Our book value per share decreased over this period primarily as a result of declines in the fair value of the assets consolidated on our balance sheets. On January 1, 2008 subsequent to the adoption of FAS 159 and the elections we made to fair value the Acacia ABS issued, our book value increased to positive \$23.18. For further details, see the Mark-to-Market Adjustments Discussion above.

**Cash Requirements, Sources of Cash, and Liquidity**

We use cash to fund our operations and securitization activities, invest in earning assets, service and repay Redwood debt, fund working capital, and fund our dividend distributions. One primary source of cash is principal and interest payments received on a monthly basis from real estate loans and securities. Other sources of cash include proceeds from sales of assets to securitizations entities, proceeds from sales of other assets, proceeds from calls of securities, borrowings, and issuance of equity and debt. We fund our riskiest credit investments with equity capital and limited the use of recourse financial leverage, especially when the macroeconomic risks facing our business are high. Our capital position continues to be strong and will provide us with options and flexibility in the future.

**Table 57 Liquidity Position**

(In Millions)	December 31, 2007
Unrestricted cash	\$ 290
Unsecuritized residential loans	5
AAA-rated residential securities	10
Liquid assets	305
Redwood debt	(8 )
Net Liquidity Position	\$ 297

At December 31, 2007, we had \$282 million of excess capital, an increase from the \$183 million with which we began the year. We derive our excess capital figures by calculating the amount of cash we have available for investment if we fully leveraged our loans and securities in accordance with our internal risk-adjusted capital policies and deducted from the resulting cash balances an amount we believe is sufficient to fund operations and working capital and provide for any liquidity risks. We include long-term subordinated notes as part of our capital base calculations.

TABLE OF CONTENTS

The table below presents changes in our excess capital for the past two years.

**Table 58 Excess Capital**

(In Millions)	2007	2006
Balance at beginning of period	\$ 183	\$ 189
Uses:		
Acquisitions	(485 )	(292 )
Dividends	(143 )	(159 )
Sources:		
Cash flow from investments after operating expenses	216	212
Securitization	184	32
Sales	92	35
Equity issuance	185	66
Subordinated notes issuance	50	100
Balance At End of Period	\$ 282	\$ 183

During 2007, we successfully raised \$190 million through our direct stock purchase and dividend reinvestment plan. These funds allow us to maintain sufficient liquidity as we look for high quality investments in our core residential and commercial credit-enhancement businesses. Our rate of excess capital utilization will depend on future market conditions, but will be grounded in strong balance sheet management. We plan to ensure capital adequacy through the duration of the current market dislocation and beyond, which requires maintaining enough excess capital to account for changing market conditions.

While we anticipate using excess capital to grow our franchise and make good long-term investments, Redwood's board of directors has authorized us to purchase up to five million shares of our common stock if we believe our shares are trading at attractive levels relative to other uses of cash. Organic growth remains our top priority; however the best use of capital is a constantly changing dynamic that is partly influenced by our current share price. Redwood stock may reach a price level that makes share buybacks the most accretive option for on shareholders.

**Contractual Obligations and Commitments**

The table below presents our contractual obligations and commitments as of December 31, 2007, as well as the obligations of the securitization entities that we sponsor and are consolidated on our balance sheets. The operating leases are commitments that are expensed based on the terms of the related contracts.

78

TABLE OF CONTENTS**Table 59 Contractual Obligations and Commitments as of December 31, 2007**

(In Thousands)	Payments Due or Commitment Expiration by Period				
	Total	Less Than 1 Year	1 to 3 Years	3 to 5 Years	After 5 Years
Redwood Obligations:					
Redwood debt	\$7,561	\$7,561	\$	\$	\$
Subordinated notes	150,000				150,000
Anticipated interest payments on Subordinated notes	321,680	10,106	17,721	20,667	273,186

Accrued interest payable	1,911	1,911			
Operating leases	15,430	1,636	3,389	3,713	6,692
Purchase commitments					
Total Redwood Obligations and Commitments	\$496,582	\$21,214	\$21,110	\$24,380	\$429,878
Obligations of Securitization Entities:					
Consolidated ABS*	\$10,329,279	\$159	\$100,249	237,344	\$9,991,527
Anticipated interest payments on ABS**	7,705,504	391,921	681,812	781,849	5,849,922
Accrued interest payable	51,885	51,885			
Total obligations of securitization entities	\$18,086,668	\$443,965	\$782,061	\$1,019,193	\$15,841,449
Total Consolidated Obligations and Commitments	\$18,583,250	\$465,179	\$803,171	\$1,043,573	\$16,271,327

\* All consolidated ABS issued are collateralized by real estate loans and securities. Although the stated maturity is as shown, the ABS obligations will pay down as the principal of these real estate loans or securities pay down.

\*\* The anticipated interest payments on consolidated ABS issued is calculated based on the contractual maturity of the ABS and therefore assumes no prepayments of the principal outstanding as of December 31, 2007.

79

## TABLE OF CONTENTS

### **Market Risks**

We seek to manage the risks inherent in our business including but not limited to credit risk, interest rate risk, prepayment risk, liquidity risk, and fair value risk in a prudent manner designed to enhance our earnings and dividends and preserve our capital. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, and to maintain capital levels consistent with these risks.

### **Credit Risk**

Integral to our core business is assuming the credit risk of real estate loans primarily through the ownership of residential and commercial real estate loans and securities. Much of our capital base is employed in owning credit-enhancement securities that have below investment-grade credit ratings due to their concentrated credit risks with respect to underlying real estate loans. We believe that many of the loans underlying these securities are above-average in credit quality as compared to U.S. real estate loans in general, but the balance and percentage of loans with special risk factors (higher risk commercial loans, interest-only and negative amortization residential loan types, and alt-a and subprime residential loans) has increased and continue to increase. We also own a wide variety of residential and commercial real estate loans of various quality grades that are not securitized.

Credit losses from any of the loans in securitized loan pools reduce the principal value of and economic returns on the lower-rated securities in these pools. Credit losses on real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; decline in the value of homes, businesses, or commercial properties; special hazards; earthquakes and other natural events; over-leveraging of the borrower or on the property; reduction in market rents and occupancies and poor property management practices; changes in legal protections for lenders; reduction in personal incomes; job loss; and personal events such as divorce or health problems. In addition, if the U.S. economy or the housing market weakens, our credit losses could increase beyond levels that we have anticipated. Credit losses on real estate loans can vary for reasons not related to the general economy.

With respect to most of the loans securitized by securitization entities sponsored by us and for a portion of the loans underlying residential loan CES we have acquired from securitizations sponsored by others, the interest rate is adjustable. Accordingly, when short-term interest rates rise, required monthly payments from homeowners may rise under the terms of these ARMs, and this may increase borrowers' delinquencies and defaults.

We also acquire credit-enhancement securities backed by negative amortization adjustable-rate loans made to residential borrowers, some of which are prime-quality loans while many are alt-a quality loans (and a few are subprime loans). We invest in these riskier loan types with the expectation of significantly higher delinquencies and losses as compared to regular amortization loans, but believe these securities offer us the opportunity to generate attractive risk-adjusted returns as a result of attractive pricing and the manner in which these securitizations are structured. Nevertheless, there remains substantial uncertainty about the future performance of these assets.

The large majority of the commercial loans we credit-enhance are fixed-rate loans, some of which are interest-only loans. In general, these loans are not fully amortizing and therefore require balloon payments at maturity. Consequently, we could be exposed to credit losses at the maturity of these loans if the borrower is unable to repay or refinance the borrowing with another third party lender.

We will experience credit losses on residential and commercial loans and CES, and to the extent the losses are consistent with the amount and timing of our assumptions, we expect to earn attractive returns on our investments. We manage our credit risks by understanding the extent of the risk we are taking and insuring the appropriate underwriting criteria are met, and we utilize systems and staff to continually monitor the ongoing credit performance of each loan and security. To the extent we find the credit risks on specific assets are changing adversely, we will take actions (including selling the assets) to mitigate potential losses. However, we may not always be successful in foreseeing adverse changes in credit performance or in effectively mitigating future credit losses.

80

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## TABLE OF CONTENTS

In addition to residential and commercial CES, the Acacia entities we sponsor own investment-grade and other securities issued by securitization entities that are sponsored by others. These securities are typically rated AAA through B, and are in a second-loss or better position or are otherwise effectively more senior in the credit structure in comparison to first-loss CES or their equivalent. A risk we face with respect to these securities is that we do not generally control or influence the underwriting, servicing, management, or loss mitigation with respect to these underlying loans.

The Acacia entities also own securities backed by subprime and alt-a residential loans that have substantially higher credit risk characteristics than prime-quality loans. Consequently, we can expect these lower-quality loans to have higher rates of delinquency and loss, and if such losses differ from our assumptions, Acacia (and thus Redwood) could suffer losses.

In addition to the foregoing, the Acacia entities own certain investment-grade, BB-rated, and B-rated residential loan securities purchased from the Sequoia securitization entities we sponsor.

These securities owned by Acacia are generally less likely to suffer credit losses than other securities since credit losses ordinarily would not occur until cumulative credit losses within the pool of securitized loans exceed the principal value of the subordinated CES underneath and other credit protections have been exhausted. However, if the pools of residential and commercial loans underlying these securities were to experience poor credit results, these Acacia securities could have their credit ratings downgraded, could suffer decreases in fair value, or could experience principal losses. If any of these events occurs, it would likely reduce our returns from the Acacia CDO equity securities we have acquired and may reduce our ability to sponsor Acacia transactions in the future.

## Interest Rate Risk

Interest rates and the shape of the yield curve can affect the cash flows and fair values of our assets, liabilities, and interest rate agreements, and consequently, affect our earnings and reported equity. Our general strategy with respect to interest rates is to maintain an asset/liability posture (including hedges) on a consolidated basis that assumes some interest rate risks but not to such a degree that the achievement of our long-term goals would likely be affected by changes in interest rates. Accordingly, we are willing to accept short-term volatility of earnings and changes in our reported equity in order to accomplish our goal of achieving attractive long-term returns.

To implement our interest rate risk strategy, we may use interest rate agreements in an effort to maintain a close match between pledged assets and Redwood debt, as well as between the interest rate characteristics of the assets in the securitization entities and the corresponding ABS issued. However, we do not attempt to completely hedge changes in interest rates, and at times, we may be subject to more interest rate risk than we generally desire in the long term. Changes in interest rates will have an impact on the values and cash flows of our assets and corresponding liabilities.

## Prepayment Risk

We seek to maintain an asset/liability posture that benefits from investments in prepayment-sensitive assets while limiting the risk of adverse prepayment fluctuations to an amount that, in most circumstances, can be absorbed by our capital base while still allowing us to make regular dividend payments.

Prepayments affect GAAP earnings in the near-term primarily through the timing of the amortization of purchase premium and discount and through triggering market valuation adjustments. For example, amortization income from discount assets may not necessarily offset amortization expense from premium assets, and vice-versa. In addition, variations in current and projected prepayment rates for individual assets and changes in interest rates (as they affect projected coupons on ARMs and other assets and thus change effective yield calculations) may cause net premium amortization expense or net discount amortization income to vary substantially from quarter to quarter. Moreover, the timing of premium amortization on assets may not always match the timing of the premium amortization on liabilities even when the underlying assets and liabilities are in the same securitization and pay down at the same rate.

With respect to securities backed by residential mortgage loans (and in particular, IO securities), changes in prepayment forecasts by market participants could affect the market prices of those securities sold by securitization entities, and thus could affect the profits we earn from securitized assets.

81

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### TABLE OF CONTENTS

Prepayment risks also exist in the assets and associated liabilities consolidated on our balance sheets. In general, discount securities (such as CES) benefit from faster prepayment rates on the underlying real estate loans while premium securities (such as IO securities) benefit from slower prepayments on the underlying loans. Our largest current potential exposure to changes in prepayment rates is on short-term residential ARM loans. We are currently biased in favor of faster prepayment speeds with respect to the long-term economic effect of ARM prepayments.

However, in the short-term, increases in ARM prepayment rates could result in GAAP earnings volatility.

Through our ownership of discount residential loan CES backed by fixed-rate and hybrid residential loans, we generally benefit from faster prepayments on those underlying loans. Prepayment rates for those loans typically accelerate as medium-and-long-term interest rates decline.

Our credit results and risks can also be affected by prepayments. For example, credit risks for the CES we own are reduced each time a loan prepays. All other factors being equal, faster prepayment rates should reduce our credit risks on our existing portfolio.

We caution that prepayment rates are difficult to predict or anticipate, and variations in prepayment rates can materially affect our earnings and dividends. ARM prepayment rates, for