

REDWOOD TRUST INC
Form 10-Q
August 08, 2018

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
 OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: June 30, 2018

OR

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

For the Transition Period from _____ to _____.
Commission File Number 1-13759

REDWOOD TRUST, INC.
(Exact Name of Registrant as Specified in Its Charter)
Maryland 68-0329422
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

One Belvedere Place, Suite 300 94941
Mill Valley, California
(Address of Principal Executive Offices) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

Common Stock, \$0.01 par value per share 82,929,990 shares outstanding as of August 6, 2018

REDWOOD TRUST, INC.
2018 FORM 10-Q REPORT
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In Thousands, except Share Data) (Unaudited)	June 30, 2018	December 31, 2017
ASSETS ⁽¹⁾		
Residential loans, held-for-sale, at fair value	\$ 1,104,660	\$ 1,427,945
Residential loans, held-for-investment, at fair value	4,386,510	3,687,265
Real estate securities, at fair value	1,453,936	1,476,510
Cash and cash equivalents	184,779	144,663
Restricted cash	15,285	2,144
Accrued interest receivable	29,066	27,013
Derivative assets	65,645	15,718
Other assets	272,670	258,564
Total Assets	\$7,512,551	\$ 7,039,822
LIABILITIES AND EQUITY ⁽¹⁾		
Liabilities		
Short-term debt ⁽²⁾	\$ 1,426,288	\$ 1,938,682
Accrued interest payable	21,925	18,435
Derivative liabilities	55,929	63,081
Accrued expenses and other liabilities	79,571	67,729
Asset-backed securities issued, at fair value	1,929,662	1,164,585
Long-term debt, net	2,770,221	2,575,023
Total liabilities	6,283,596	5,827,535
Equity		
Common stock, par value \$0.01 per share, 180,000,000 shares authorized; 75,742,719 and 76,599,972 issued and outstanding	757	766
Additional paid-in capital	1,665,749	1,673,845
Accumulated other comprehensive income	75,620	85,248
Cumulative earnings	1,369,933	1,290,341
Cumulative distributions to stockholders	(1,883,104)	(1,837,913)
Total equity	1,228,955	1,212,287
Total Liabilities and Equity	\$7,512,551	\$ 7,039,822

Our consolidated balance sheets include assets of consolidated variable interest entities (“VIEs”) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have (1) recourse to Redwood Trust, Inc. or its affiliates. At June 30, 2018 and December 31, 2017, assets of consolidated VIEs totaled \$2,082,771 and \$1,259,774, respectively. At June 30, 2018 and December 31, 2017, liabilities of consolidated VIEs totaled \$1,935,299 and \$1,167,157, respectively. See Note 4 for further discussion.

(2) At December 31, 2017, balance includes \$250 million of convertible notes, which were reclassified from Long-term debt, net to Short-term debt as the notes matured in April 2018. See Note 10 for further discussion.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, except Share Data) (Unaudited)	Three Months Ended		Six Months Ended	
	June 30, 2018	2017	June 30, 2018	2017
Interest Income				
Residential loans	\$55,514	\$ 36,635	\$ 105,745	\$ 70,997
Real estate securities	26,296	21,826	51,991	41,643
Other interest income	1,166	763	1,859	1,212
Total interest income	82,976	59,224	159,595	113,852
Interest Expense				
Short-term debt	(13,175)	(9,350)	(26,610)	(13,803)
Asset-backed securities issued	(16,349)	(3,705)	(27,750)	(7,235)
Long-term debt	(18,689)	(11,179)	(35,367)	(24,227)
Total interest expense	(48,213)	(24,234)	(89,727)	(45,265)
Net Interest Income	34,763	34,990	69,868	68,587
Non-interest Income				
Mortgage banking activities, net	10,596	12,046	37,172	29,650
Investment fair value changes, net	889	8,115	2,498	9,666
Other income, net	3,322	3,764	5,440	6,661
Realized gains, net	4,714	1,372	14,077	7,075
Total non-interest income, net	19,521	25,297	59,187	53,052
Operating expenses	(19,009)	(18,641)	(42,039)	(36,867)
Net Income before Provision for Income Taxes	35,275	41,646	87,016	84,772
Provision for income taxes	(2,528)	(5,322)	(7,424)	(11,479)
Net Income	\$32,747	\$ 36,324	\$79,592	\$ 73,293
Basic earnings per common share	\$0.42	\$ 0.46	\$ 1.02	\$ 0.93
Diluted earnings per common share	\$0.38	\$ 0.43	\$0.88	\$ 0.85
Regular dividends declared per common share	\$0.30	\$ 0.28	\$0.58	\$ 0.56
Basic weighted average shares outstanding	75,380,715	76,819,703	75,388,638	76,779,178
Diluted weighted average shares outstanding	100,431,997	97,494,144	104,291,180	97,718,550

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

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

(In Thousands)	Three Months		Six Months Ended	
(Unaudited)	Ended June 30,		June 30,	
	2018	2017	2018	2017
Net Income	\$32,747	\$36,324	\$79,592	\$73,293
Other comprehensive (loss) income:				
Net unrealized (loss) gain on available-for-sale securities ⁽¹⁾	(3,104)	1,811	(7,341)	4,741
Reclassification of unrealized gain on available-for-sale securities to net income	(4,748)	(2,322)	(14,135)	(6,250)
Net unrealized gain (loss) on interest rate agreements	3,417	(2,429)	11,848	(696)
Reclassification of unrealized loss on interest rate agreements to net income	—	14	—	28
Total other comprehensive (loss) income	(4,435)	(2,926)	(9,628)	(2,177)
Total Comprehensive Income	\$28,312	\$33,398	\$69,964	\$71,116

Amounts are presented net of tax benefit (provision) of \$0.2 million and \$0.1 million for the three and six months (1)ended June 30, 2018, respectively, and \$0.1 million and \$(0.1) million for the three and six months ended June 30, 2017, respectively.

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

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

For the Six Months Ended June 30, 2018

(In Thousands, except Share Data) (Unaudited)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
	Shares	Amount					
December 31, 2017	76,599,972	\$ 766	\$ 1,673,845	\$ 85,248	\$ 1,290,341	\$(1,837,913)	\$ 1,212,287
Net income	—	—	—	—	79,592	—	79,592
Other comprehensive loss	—	—	—	(9,628)	—	—	(9,628)
Employee stock purchase and incentive plans	183,576	1	(195)	—	—	—	(194)
Non-cash equity award compensation	—	—	7,633	—	—	—	7,633
Share repurchases	(1,040,829)	(10)	(15,534)	—	—	—	(15,544)
Common dividends declared	—	—	—	—	—	(45,191)	(45,191)
June 30, 2018	75,742,719	\$ 757	\$ 1,665,749	\$ 75,620	\$ 1,369,933	\$(1,883,104)	\$ 1,228,955

For the Six Months Ended June 30, 2017

(In Thousands, except Share Data) (Unaudited)	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
	Shares	Amount					
December 31, 2016	76,834,663	\$ 768	\$ 1,676,486	\$ 71,853	\$ 1,149,935	\$(1,749,614)	\$ 1,149,428
Net income	—	—	—	—	73,293	—	73,293
Other comprehensive loss	—	—	—	(2,177)	—	—	(2,177)
Employee stock purchase and incentive plans	282,212	3	(2,388)	—	—	—	(2,385)
Non-cash equity award compensation	—	—	5,377	—	—	—	5,377
Common dividends declared	—	—	—	—	—	(44,112)	(44,112)
June 30, 2017	77,116,875	\$ 771	\$ 1,679,475	\$ 69,676	\$ 1,223,228	\$(1,793,726)	\$ 1,179,424

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

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

(In Thousands) (Unaudited)	Six Months Ended June 30,	
	2018	2017
Cash Flows From Operating Activities:		
Net income	\$79,592	\$73,293
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(7,963)	(9,638)
Depreciation and amortization of non-financial assets	582	605
Purchases of held-for-sale loans	(3,772,494)	(2,309,856)
Proceeds from sales of held-for-sale loans	2,966,508	2,031,326
Principal payments on held-for-sale loans	30,656	22,093
Net settlements of derivatives	40,426	776
Non-cash equity award compensation expense	7,633	5,377
Market valuation adjustments	(34,136)	(30,743)
Realized gains, net	(14,077)	(7,075)
Net change in:		
Accrued interest receivable and other assets	32,478	(26,226)
Accrued interest payable and accrued expenses and other liabilities	(3,582)	(16,840)
Net cash used in operating activities	(674,377)	(266,908)
Cash Flows From Investing Activities:		
Principal payments on loans held-for-investment	335,720	258,267
Purchases of real estate securities	(319,975)	(236,036)
Proceeds from sales of real estate securities	352,563	99,121
Principal payments on real estate securities	33,974	34,752
Sales (purchases) of mortgage servicing rights, net	6,064	42,861
(Funding) payments of participation in loan warehouse facility, net	(34,333)	—
Other investing activities, net	(9,999)	—
Net cash provided by investing activities	364,014	198,965
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	3,219,350	2,070,873
Repayments on short-term debt	(3,731,917)	(1,855,233)
Proceeds from issuance of asset-backed securities	925,845	—
Repayments on asset-backed securities issued	(181,781)	(103,371)
Proceeds from issuance of long-term debt	199,000	—
Deferred long-term debt issuance costs paid	(4,940)	—
Net settlements of derivatives	(237)	(72)
Net proceeds from issuance of common stock	177	145
Net payments on repurchase of common stock	(16,315)	—
Taxes paid on equity award distributions	(371)	(2,530)
Dividends paid	(45,191)	(44,112)
Net cash provided by financing activities	363,620	65,700
Net increase (decrease) in cash, cash equivalents and restricted cash	53,257	(2,243)
Cash, cash equivalents and restricted cash at beginning of period ⁽¹⁾	146,807	221,467
Cash, cash equivalents, and restricted cash at end of period ⁽¹⁾	\$200,064	\$219,224
Supplemental Cash Flow Information:		
Cash paid during the period for:		
Interest	\$83,781	\$44,274
Taxes	3,722	1,040

Supplemental Noncash Information:

Real estate securities retained from loan securitizations	\$43,513	\$38,051
Retention of mortgage servicing rights from loan securitizations and sales	—	7,387
Transfers from loans held-for-sale to loans held-for-investment	1,069,326	247,377
Transfers from loans held-for-investment to loans held-for-sale	—	459
Transfers from residential loans to real estate owned	1,835	2,044
Transfers from long-term debt to short-term debt	—	285,900

Cash, cash equivalents, and restricted cash at June 30, 2018 includes cash and cash equivalents of \$185 million and (1)restricted cash of \$15 million, and at December 31, 2017 includes cash and cash equivalents of \$145 million and restricted cash of \$2 million.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018
(Unaudited)

Note 1. Organization

Redwood Trust, Inc., together with its subsidiaries, is a specialty finance company focused on making credit-sensitive investments in residential mortgages and related assets and engaging in mortgage banking activities. Our goal is to provide attractive returns to shareholders through a stable and growing stream of earnings and dividends, as well as through capital appreciation. We operate our business in two segments: Investment Portfolio and Residential Mortgage Banking.

Our primary sources of income are net interest income from our investment portfolios and non-interest income from our mortgage banking activities. Net interest income consists of the interest income we earn on investments less the interest expense we incur on borrowed funds and other liabilities. Income from mortgage banking activities is generated through the acquisition of loans and their subsequent sale or securitization.

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code"), beginning with its taxable year ended December 31, 1994. We generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as "the REIT" or "our REIT." We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as "our operating subsidiaries" or "our taxable REIT subsidiaries" or "TRS."

Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. References herein to "Redwood," the "company," "we," "us," and "our" include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires.

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2018 and December 31, 2017, and for the three and six months ended June 30, 2018 and 2017. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in our annual financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") — as prescribed by the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") — have been condensed or omitted in these interim financial statements according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the company's Annual Report on Form 10-K for the year ended December 31, 2017. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at June 30, 2018 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2018 should not be construed as indicative of the results to be expected for the full year.

Principles of Consolidation

In accordance with GAAP, we determine whether we must consolidate transferred financial assets and variable interest entities ("VIEs") for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities issued prior to 2012 where we maintain an ongoing involvement ("Legacy Sequoia"), as well as entities formed in connection with the securitization of Redwood Choice expanded-prime loans beginning in the third quarter of 2017 ("Sequoia Choice"). Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, servicing administrator, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

For financial reporting purposes, the underlying loans owned at the consolidated Sequoia entities are shown under Residential loans, held-for-investment, at fair value on our consolidated balance sheets. The asset-backed securities (“ABS”) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we recorded interest income on the loans owned at these entities and interest expense on the ABS issued by these entities as well as other income and expenses associated with these entities' activities. See Note 11 for further discussion on ABS issued.

See Note 4 for further discussion on principles of consolidation.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018

(Unaudited)

Note 2. Basis of Presentation - (continued)

Use of Estimates

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

Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies

Included in Note 3 to the Consolidated Financial Statements of our 2017 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company's consolidated financial position and results of operations for the three and six months ended June 30, 2018.

Recent Accounting Pronouncements

Newly Adopted Accounting Standards Updates ("ASUs")

In May 2017, the FASB issued ASU 2017-09, "Compensation - Stock Compensation (Topic 718)." This new guidance provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. This new guidance is effective for fiscal years beginning after December 15, 2017, and should be applied prospectively to an award modified on or after the adoption date. We adopted this guidance, as required, in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash." This new guidance amends previous guidance on how to classify and present changes in restricted cash on the statement of cash flows. This new guidance is effective for fiscal years beginning after December 15, 2017. We adopted this guidance, as required, in the first quarter of 2018, which did not have a material impact on our results of operations but impacted the presentation of the statements of cash flows and related footnote disclosures.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory." This new guidance allows an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. It also eliminates the exceptions for an intra-entity transfer of assets other than inventory. This new guidance is effective for fiscal years beginning after December 15, 2017. We adopted this guidance, as required, in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." This new guidance provides guidance on how to present and classify certain cash receipts and cash payments in the statement of cash flows. This new guidance is effective for fiscal years beginning after December 15, 2017. We adopted this guidance, as required, in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." This new guidance amends accounting related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. This new guidance also amends certain disclosure requirements associated with the fair value of financial instruments and it is effective for fiscal years beginning after December 15, 2017. In February 2018, the FASB issued ASU 2018-03,

"Technical Corrections and Improvements to Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities," which clarified certain aspects of the guidance issued in ASU 2016-01. We adopted this guidance, as required, in the first quarter of 2018. This did not have a material impact on our consolidated financial statements as our investments in debt securities and loans were not subject to the amendments in this ASU. In accordance with this guidance, we amended certain fair value disclosures related to financial instruments that are carried at amortized cost on the consolidated balance sheets.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018
(Unaudited)

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

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers." The update modifies the guidance companies use to recognize revenue from contracts with customers for transfers of goods or services and transfers of nonfinancial assets, unless those contracts are within the scope of other standards. The guidance also requires new qualitative and quantitative disclosures, including information about contract balances and performance obligations. In July 2015, the FASB approved a one-year deferral of the effective date. Accordingly, the update is effective for us in the first quarter of 2018 with retrospective application to prior periods presented or as a cumulative effect adjustment in the period of adoption. In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)." This new guidance provides additional implementation guidance on how an entity should identify the unit of accounting for the principal versus agent evaluations. In May 2016, the FASB issued ASU 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients," and in December 2016, the FASB issued ASU 2016-20, "Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers." These new ASUs provide more specific guidance on certain aspects of Topic 606. In September 2017, the FASB issued ASU 2017-13, "Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments (SEC Update)." This new ASU allows certain public business entities to use the nonpublic business entity effective dates for adoption of the new revenue standard. In November 2017, the FASB issued ASU 2017-14, "Income Statement - Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue from Contracts with Customers (Topic 606): Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 116 and SEC Release No. 33-10403." This new ASU amends various paragraphs that contain SEC guidance. We adopted this guidance, as required, in the first quarter of 2018. This did not have a material impact on our consolidated financial statements as nearly all of our income is generated from financial instruments, which are explicitly scoped out of these standards.

Other Recent Accounting Pronouncements

In February 2018, the FASB issued ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." This new guidance allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." This new guidance amends previous guidance to better align an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

In July 2017, the FASB issued ASU 2017-11, "Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception." This new guidance changes the classification analysis of certain equity-linked financial instruments (or embedded

conversion options) with down round features. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20)." This new guidance shortens the amortization period for certain callable debt securities purchased at a premium by requiring the premium to be amortized to the earliest call date. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 3. Summary of Significant Accounting Policies - (continued)

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses." This new guidance provides a new impairment model that is based on expected losses rather than incurred losses to determine the allowance for credit losses. This new guidance is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted for fiscal years beginning December 15, 2018. We currently have only a small balance of loans receivable that are not carried at fair value and would be subject to this new guidance for allowance for credit losses. Separately, we account for our available-for-sale securities under the other-than-temporary impairment ("OTTI") model for debt securities. This new guidance requires that credit impairments on our available-for-sale securities be recorded in earnings using an allowance for credit losses, with the allowance limited to the amount by which the security's fair value is less than its amortized cost basis. Subsequent reversals in credit loss estimates are recognized in income. We plan to adopt this new guidance by the required date and continue to evaluate the impact that this update will have on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases." This new guidance requires lessees to recognize most leases on their balance sheet as a right-of-use asset and a lease liability. This new guidance retains a dual lease accounting model, which requires leases to be classified as either operating or capital leases for lessees, for purposes of income statement recognition. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. In July 2018, the FASB issued ASU 2018-10, "Codification Improvements to Topic 842, Leases," which provides more specific guidance on certain aspects of Topic 842. Additionally, in July 2018, the FASB issued ASU 2018-11, "Leases (Topic 842): Targeted Improvements." This new ASU introduces an additional transition method which allows entities to apply the new standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. As discussed in Note 13, our only material leases are those related to our leased office space, for which future payments under these leases totaled \$17 million at June 30, 2018. Upon adoption of this standard in the first quarter of 2019, we will record a right-of-use asset and lease liability equal to the present value of these future lease payments discounted at our incremental borrowing rate. Based on our initial evaluation of this new guidance, and taking into consideration our current in-place leases, we do not expect that its adoption will have a material impact on our consolidated financial statements. We will continue evaluating this new standard and caution that any changes in our business or additional leases we may enter into could change our initial assessment.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 3. Summary of Significant Accounting Policies - (continued)

Balance Sheet Netting

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

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at June 30, 2018 and December 31, 2017.

Table 3.1 – Offsetting of Financial Assets, Liabilities, and Collateral

June 30, 2018 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet ⁽¹⁾ Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets ⁽²⁾						
Interest rate agreements	\$59,468	\$	—\$59,468	\$(12,372)	\$(6,803)	\$40,293
TBAs	3,186	—	3,186	(2,568)	(481)	137
Total Assets	\$62,654	\$	—\$62,654	\$(14,940)	\$(7,284)	\$40,430
Liabilities ⁽²⁾						
Interest rate agreements	\$(44,730)	\$	—\$(44,730)	\$12,372	\$32,358	\$—
TBAs	(6,372)	—	(6,372)	2,568	3,804	—
Futures	(126)	—	(126)	—	126	—
Loan warehouse debt	(719,394)	—	(719,394)	719,394	—	—
Security repurchase agreements	(706,894)	—	(706,894)	706,894	—	—
Total Liabilities	\$(1,477,516)	\$	—\$(1,477,516)	\$1,441,228	\$36,288	\$—

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 3. Summary of Significant Accounting Policies - (continued)

December 31, 2017 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet ⁽¹⁾ Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets ⁽²⁾						
Interest rate agreements	\$ 10,164	\$ —	—\$ 10,164	\$ (6,196)	\$ (42)	\$ 3,926
TBAs	133	—	133	(133)	—	—
Futures	1	—	1	—	—	1
Total Assets	\$ 10,298	\$ —	—\$ 10,298	\$ (6,329)	\$ (42)	\$ 3,927
Liabilities ⁽²⁾						
Interest rate agreements	\$ (55,567)	\$ —	—\$ (55,567)	\$ 6,196	\$ 49,371	\$ —
TBAs	(3,808)	—	(3,808)	133	1,376	(2,299)
Loan warehouse debt	(1,039,666)	—	(1,039,666)	1,039,666	—	—
Security repurchase agreements	(648,746)	—	(648,746)	648,746	—	—
Total Liabilities	\$ (1,747,787)	\$ —	—\$ (1,747,787)	\$ 1,694,741	\$ 50,747	\$ (2,299)

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

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018

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Note 4. Principles of Consolidation

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

Analysis of Consolidated VIEs

At June 30, 2018, we consolidated certain of our Legacy Sequoia and Sequoia Choice securitization entities that we determined were VIEs and for which we determined we were the primary beneficiary. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, servicing administrator, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. At June 30, 2018, the estimated fair value of our investments in the consolidated Legacy Sequoia and Sequoia Choice entities was \$13 million and \$135 million, respectively. The following table presents a summary of the assets and liabilities of these VIEs.

Table 4.1 – Assets and Liabilities of Consolidated VIEs

June 30, 2018	Legacy Sequoia	Sequoia Choice	Total Consolidated VIEs
(Dollars in Thousands)			
Residential loans, held-for-investment	\$592,029	\$1,481,145	\$2,073,174
Restricted cash	147	10	157
Accrued interest receivable	835	5,956	6,791
REO	2,649	—	2,649
Total Assets	\$595,660	\$1,487,111	\$2,082,771
Accrued interest payable	\$589	\$5,038	\$5,627
Accrued expenses and other liabilities	—	10	10
Asset-backed securities issued	582,235	1,347,427	1,929,662
Total Liabilities	\$582,824	\$1,352,475	\$1,935,299
Number of VIEs	20	4	24

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation - (continued)

December 31, 2017 (Dollars in Thousands)	Legacy Sequoia	Sequoia Choice	Total Consolidated VIEs
Residential loans, held-for-investment	\$632,817	\$620,062	\$ 1,252,879
Restricted cash	147	4	151
Accrued interest receivable	867	2,524	3,391
REO	3,353	—	3,353
Total Assets	\$637,184	\$622,590	\$ 1,259,774
Accrued interest payable	\$537	\$2,031	\$ 2,568
Accrued expenses and other liabilities	—	4	4
Asset-backed securities issued	622,445	542,140	1,164,585
Total Liabilities	\$622,982	\$544,175	\$ 1,167,157

Number of VIEs	20	2	22
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We consolidate the assets and liabilities of certain Sequoia securitization entities, as we did not meet the GAAP sale criteria at the time we transferred financial assets to these entities. Our involvement in consolidated Sequoia entities continues in the following ways: (i) we continue to hold subordinate investments in each entity, and for certain entities, more senior investments; (ii) we maintain certain discretionary rights associated with our sponsorship of, or our subordinate investments in, each entity; and (iii) we continue to hold a right to call the assets of certain entities (once they have been paid down below a specified threshold) at a price equal to, or in excess of, the current outstanding principal amount of the entity's asset-backed securities issued. These factors have resulted in our continuing to consolidate the assets and liabilities of these Sequoia entities in accordance with GAAP.

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 42 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes, in accordance with ASC 860. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For certain of these transfers to securitization entities, for the transferred loans where we held the servicing rights prior to the transfer and continued to hold the servicing rights following the transfer, we recorded MSR on our consolidated balance sheets, and classified those MSR as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets. Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining servicing rights (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.

The following table presents information related to securitization transactions that occurred during the three and six months ended June 30, 2018 and 2017.

Table 4.2 – Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended		Six Months Ended June	
	June 30, 2018	2017	2018	2017
Principal balance of loans transferred	\$1,127,665	\$348,599	\$2,408,133	\$1,384,123
Trading securities retained, at fair value	33,757	10,287	46,248	30,990
AFS securities retained, at fair value	2,047	1,905	5,952	7,060

MSRs recognized	—	—	—	7,123
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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation - (continued)

The following table summarizes the cash flows during the three and six months ended June 30, 2018 and 2017 between us and the unconsolidated VIEs sponsored by us and accounted for as sales since 2012.

Table 4.3 – Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended		Six Months Ended June	
	June 30,	June 30,	30,	30,
	2018	2017	2018	2017
Proceeds from new transfers	\$1,104,094	\$351,485	\$2,393,781	\$1,373,509
MSR fees received	3,397	3,698	6,811	7,173
Funding of compensating interest, net	(31) (41) (56) (79
Cash flows received on retained securities	7,410	6,588	14,453	12,961

The following table presents the key weighted-average assumptions used to measure MSRs and securities retained at the date of securitization for securitizations completed during the three and six months ended June 30, 2018 and 2017.

Table 4.4 – Assumptions Related to Assets Retained from Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended June 30,				Three Months Ended June 30,				
	2018				2017				
At Date of Securitization	MSRs	Senior IO Securities	Subordinate Securities	MSRs	Senior IO Securities	Subordinate Securities	MSRs	Senior IO Securities	Subordinate Securities
Prepayment rates	N/A	10 %	10 %	N/A	10 %	10 %	N/A	10 %	10 %
Discount rates	N/A	14 %	5 %	N/A	14 %	5 %	N/A	14 %	5 %
Credit loss assumptions	N/A	0.20 %	0.20 %	N/A	0.25 %	0.25 %	N/A	0.25 %	0.25 %
	Six Months Ended June 30,				Six Months Ended June 30,				
	2018				2017				
At Date of Securitization	MSRs	Senior IO Securities	Subordinate Securities	MSRs	Senior IO Securities	Subordinate Securities	MSRs	Senior IO Securities	Subordinate Securities
Prepayment rates	N/A	9 %	10 %	9 %	10 %	10 %	9 %	10 %	10 %
Discount rates	N/A	14 %	5 %	11 %	12 %	5 %	N/A	0.25 %	0.25 %
Credit loss assumptions	N/A	0.20 %	0.20 %	N/A	0.25 %	0.25 %	N/A	0.25 %	0.25 %

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Note 4. Principles of Consolidation - (continued)

The following table presents additional information at June 30, 2018 and December 31, 2017, related to unconsolidated VIEs sponsored by Redwood and accounted for as sales since 2012.

Table 4.5 – Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	June 30, 2018	December 31, 2017
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	\$ 127,861	\$ 101,426
Subordinate securities, classified as AFS	164,498	219,255
Mortgage servicing rights	63,176	60,980
Maximum loss exposure ⁽¹⁾	\$355,535	\$ 381,661
Assets transferred:		
Principal balance of loans outstanding	\$10,277,901	\$ 8,364,148
Principal balance of loans 30+ days delinquent	30,571	27,926

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

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at June 30, 2018 and December 31, 2017.

Table 4.6 – Key Assumptions and Sensitivity Analysis for Assets Retained from Unconsolidated VIEs Sponsored by Redwood

June 30, 2018	MSRs	Senior Securities (1)	Subordinate Securities
(Dollars in Thousands)			
Fair value at June 30, 2018	\$63,176	\$59,628	\$232,731
Expected life (in years) ⁽²⁾	9	7	15
Prepayment speed assumption (annual CPR) ⁽²⁾	7	% 10	% 10
Decrease in fair value from:			
10% adverse change	\$ 1,742	\$ 2,142	\$ 603
25% adverse change	4,221	5,100	1,487
Discount rate assumption ⁽²⁾	11	% 11	% 6
Decrease in fair value from:			
100 basis point increase	\$2,571	\$2,204	\$22,194
200 basis point increase	4,972	4,249	41,045
Credit loss assumption ⁽²⁾	N/A	0.20	% 0.20
Decrease in fair value from:			
10% higher losses	N/A	\$—	\$1,384
25% higher losses	N/A	—	3,444

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation - (continued)

December 31, 2017 (Dollars in Thousands)	MSRs	Senior Securities (1)	Subordinate Securities
Fair value at December 31, 2017	\$60,980	\$33,773	\$286,908
Expected life (in years) (2)	8	6	13
Prepayment speed assumption (annual CPR) (2)	9	% 10	% 11
Decrease in fair value from:			
10% adverse change	\$2,022	\$1,371	\$611
25% adverse change	4,839	3,289	1,506
Discount rate assumption (2)	11	% 11	% 5
Decrease in fair value from:			
100 basis point increase	\$2,386	\$1,158	\$25,827
200 basis point increase	4,597	2,265	47,885
Credit loss assumption (2)	N/A	0.25	% 0.25
Decrease in fair value from:			
10% higher losses	N/A	\$—	\$1,551
25% higher losses	N/A	—	3,873

(1) Senior securities included \$60 million and \$34 million of interest-only securities at June 30, 2018 and December 31, 2017, respectively.

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

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at June 30, 2018, grouped by security type.

Table 4.7 – Third-Party Sponsored VIE Summary

(Dollars in Thousands)	June 30, 2018	December 31, 2017
Mortgage-Backed Securities		
Senior	\$226,191	\$177,191
Mezzanine	536,700	38,875
Subordinate	398,686	939,763
Total Investments in Third-Party Sponsored VIEs	\$1,161,577	\$1,155,829

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

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

material impact to our financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments

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

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

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

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at June 30, 2018 and December 31, 2017.

Table 5.1 – Carrying Values and Fair Values of Assets and Liabilities

(In Thousands)	June 30, 2018		December 31, 2017	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	\$1,104,545	\$1,104,545	\$1,427,052	\$1,427,052
At lower of cost or fair value	115	135	893	993
Residential loans, held-for-investment				
At fair value	4,386,510	4,386,510	3,687,265	3,687,265
Trading securities	1,054,295	1,054,295	968,844	968,844
Available-for-sale securities	399,641	399,641	507,666	507,666
Cash and cash equivalents	184,779	184,779	144,663	144,663
Restricted cash	15,285	15,285	2,144	2,144
Accrued interest receivable	29,066	29,066	27,013	27,013
Derivative assets	65,645	65,645	15,718	15,718
MSRs ⁽¹⁾	64,674	64,674	63,598	63,598
REO ⁽¹⁾	2,649	3,534	3,354	3,806
Margin receivable ⁽¹⁾	49,538	49,538	85,044	85,044
FHLBC stock ⁽¹⁾	43,393	43,393	43,393	43,393
Guarantee asset ⁽¹⁾	2,936	2,936	2,869	2,869
Pledged collateral ⁽¹⁾	42,201	42,201	42,615	42,615
Participation in loan warehouse facility ⁽¹⁾	41,658	41,658	—	—
Liabilities				
Short-term debt facilities	\$1,426,288	\$1,426,288	\$1,688,412	\$1,688,412
Accrued interest payable	21,925	21,925	18,435	18,435
Margin payable ⁽²⁾	7,282	7,282	390	390
Guarantee obligation ⁽²⁾	18,124	17,903	19,487	18,878
Derivative liabilities	55,929	55,929	63,081	63,081
ABS issued at fair value, net	1,929,662	1,929,662	1,164,585	1,164,585
FHLBC long-term borrowings	1,999,999	1,999,999	1,999,999	1,999,999
Convertible notes, net	631,663	639,204	686,759	692,369
Trust preferred securities and subordinated notes, net	138,559	107,415	138,535	103,230

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

(2) These liabilities are included in Accrued expenses and other liabilities on our consolidated balance sheets.

During the three and six months ended June 30, 2018, we elected the fair value option for \$60 million and \$72 million of residential senior securities, \$161 million and \$289 million of subordinate securities, and \$1.93 billion and \$3.73 billion of residential loans (principal balance), respectively. We anticipate electing the fair value option for all future purchases of residential loans that we intend to sell to third parties or transfer to securitizations, as well as for MSRs

retained from sales of residential loans, and for certain securities we purchase, including IO securities and fixed-rate securities rated investment grade or higher.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at June 30, 2018 and December 31, 2017, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

Table 5.2 – Assets and Liabilities Measured at Fair Value on a Recurring Basis

June 30, 2018 (In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Assets				
Residential loans	\$5,491,055	\$—	\$—	\$5,491,055
Trading securities	1,054,295	—	—	1,054,295
Available-for-sale securities	399,641	—	—	399,641
Derivative assets	65,645	3,186	59,468	2,991
MSRs	64,674	—	—	64,674
Pledged collateral	42,201	42,201	—	—
FHLBC stock	43,393	—	43,393	—
Guarantee asset	2,936	—	—	2,936
Liabilities				
Derivative liabilities	\$55,929	\$6,498	\$44,730	\$4,701
ABS issued	1,929,662	—	—	1,929,662
December 31, 2017 (In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Assets				
Residential loans	\$5,114,317	\$—	\$—	\$5,114,317
Trading securities	968,844	—	—	968,844
Available-for-sale securities	507,666	—	—	507,666
Derivative assets	15,718	134	10,164	5,420
MSRs	63,598	—	—	63,598
Pledged collateral	42,615	42,615	—	—
FHLBC stock	43,393	—	43,393	—
Guarantee asset	2,869	—	—	2,869
Liabilities				
Derivative liabilities	\$63,081	\$3,808	\$55,567	\$3,706
ABS issued	1,164,585	—	—	1,164,585

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the six months ended June 30, 2018.

Table 5.3 – Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis

(In Thousands)	Assets						Liabilities
	Residential Loans	Trading Securities	AFS Securities	MSRs	Guarantee Asset	Derivatives ⁽¹⁾	ABS Issued
Beginning balance - December 31, 2017	\$5,114,317	\$968,844	\$507,666	\$63,598	\$ 2,869	\$ 1,714	\$1,164,585
Acquisitions	3,766,510	361,535	5,952	—	—	—	925,845
Sales	(3,002,879)	(260,119)	(92,110)	(1,077)	—	—	—
Principal paydowns	(365,392)	(11,748)	(22,226)	—	—	—	(181,782)
Gains (losses) in net income, net	(19,665)	(4,217)	21,930	2,153	67	(9,681)	21,014
Unrealized losses in OCI, net	—	—	(21,571)	—	—	—	—
Other settlements, net ⁽²⁾	(1,836)	—	—	—	—	6,257	—
Ending Balance - June 30, 2018	\$5,491,055	\$1,054,295	\$399,641	\$64,674	\$ 2,936	\$ (1,710)	\$1,929,662

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

Other settlements, net for residential loans represents the transfer of loans to REO, and for derivatives, the (2) settlement of forward sale commitments and the transfer of the fair value of loan purchase commitments at the time loans are acquired to the basis of residential loans.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at June 30, 2018 and 2017. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and six months ended June 30, 2018 and 2017 are not included in this presentation.

Table 5.4 – Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2018 and 2017 Included in Net Income

(In Thousands)	Included in Net Income			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Assets				
Residential loans at Redwood	\$(12,981)	\$16,506	\$(51,029)	\$19,738
Residential loans at consolidated Sequoia entities	367	11,038	20,914	19,452
Trading securities	(1,989)	15,880	(6,011)	24,529
Available-for-sale securities	(56)	(128)	(56)	(245)
MSRs	689	(2,038)	4,610	(1,354)
Loan purchase commitments	2,835	994	2,901	1,111
Other assets - Guarantee asset	(120)	(558)	66	(804)
Liabilities				
Loan purchase commitments	\$(4,646)	\$—	\$(4,687)	\$—
ABS issued	(279)	(11,977)	(21,014)	(22,516)

The following table presents information on assets recorded at fair value on a non-recurring basis at June 30, 2018. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our consolidated balance sheets at June 30, 2018.

Table 5.5 – Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at June 30, 2018

June 30, 2018	Carrying Value	Fair Value Measurements Using		Gain (Loss) for	
		Level 1	Level 2	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
(In Thousands)					
Assets					
REO	\$ 1,841	\$ —	—\$ 1,841	\$(4)	\$(127)

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the net market valuation gains and losses recorded in each line item of our consolidated statements of income for the three and six months ended June 30, 2018 and 2017.

Table 5.6 – Market Valuation Gains and Losses, Net

(In Thousands)	Three Months		Six Months Ended	
	Ended June 30, 2018	2017	2018	2017
Mortgage Banking Activities, Net				
Residential loans held-for-sale, at fair value	\$6,122	\$5,784	\$10,896	\$14,316
Residential loan purchase and forward sale commitments	(2,758)	10,406	(9,726)	20,671
Risk management derivatives, net	6,150	(5,310)	34,582	(6,710)
Total mortgage banking activities, net ⁽¹⁾	\$9,514	\$10,880	\$35,752	\$28,277
Investment Fair Value Changes, Net				
Residential loans held-for-investment, at Redwood	\$(15,010)	\$8,354	\$(53,995)	\$6,021
Trading securities	(930)	18,926	(3,885)	30,069
Valuation adjustments on commercial loans held-for-sale	—	300	—	300
Net investments in Legacy Sequoia entities ⁽²⁾	(720)	(987)	(728)	(2,797)
Net investments in Sequoia Choice entities ⁽²⁾	1,072	—	986	—
Risk-sharing investments	(209)	(513)	(348)	(718)
Risk management derivatives, net	16,742	(17,838)	60,524	(22,965)
Impairments on AFS securities	(56)	(127)	(56)	(244)
Total investment fair value changes, net	\$889	\$8,115	\$2,498	\$9,666
Other Income, Net				
MSRs	\$(745)	\$(6,421)	\$2,147	\$(9,491)
MSR risk management derivatives, net	(1,122)	3,040	(6,261)	2,291
Total other income, net ⁽³⁾	\$(1,867)	\$(3,381)	\$(4,114)	\$(7,200)
Total Market Valuation Gains, Net	\$8,536	\$15,614	\$34,136	\$30,743

Mortgage banking activities, net presented above does not include fee income or provisions for repurchases that are (1) components of Mortgage banking activities, net presented on our consolidated statements of income, as these amounts do not represent market valuation changes.

(2) Includes changes in fair value of the residential loans held-for-investment, REO and the ABS issued at the entities, which netted together represent the change in value of our retained investments at the consolidated VIEs.

(3) Other income, net presented above does not include net MSR fee income or provisions for repurchases for MSRs, as these amounts do not represent market valuation adjustments.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

At June 30, 2018, our valuation policy and processes had not changed from those described in our Annual Report on Form 10-K for the year ended December 31, 2017. The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

Table 5.7 – Fair Value Methodology for Level 3 Financial Instruments

June 30, 2018 (Dollars in Thousands, except Input Values)	Fair Value	Unobservable Input	Input Values Range			Weighted Average	
Assets							
Residential loans, at fair value:							
Jumbo fixed-rate loans	\$2,676,132	Whole loan spread to TBA price	\$2.00	-\$3.28		\$2.97	
		Whole loan spread to swap rate	90	-206	bps	202	bps
Jumbo hybrid loans	276,844	Prepayment rate (annual CPR)	15	-15	%	15	%
		Whole loan spread to swap rate	75	-160	bps	133	bps
Jumbo loans committed to sell	464,905	Whole loan committed sales price	\$100.58-\$101.94			\$101.45	
Loans held by Legacy Sequoia ⁽¹⁾	592,029	Liability price	N/A			N/A	
Loans held by Sequoia Choice ⁽¹⁾	1,481,145	Liability price	N/A			N/A	
Trading and AFS securities	1,453,936	Discount rate	3	-14	%	6	%
		Prepayment rate (annual CPR)	—	-50	%	9	%
		Default rate	—	-27	%	2	%
		Loss severity	—	-40	%	22	%
MSRs	64,674	Discount rate	11	-43	%	11	%
		Prepayment rate (annual CPR)	6	-26	%	7	%
		Per loan annual cost to service	\$82	-\$82		\$82	
Guarantee asset	2,936	Discount rate	11	-11	%	11	%
		Prepayment rate (annual CPR)	8	-8	%	8	%
REO	1,841	Loss severity	13	-43	%	29	%
Liabilities							
ABS issued ⁽¹⁾	1,929,662	Discount rate	3	-15	%	4	%
		Prepayment rate (annual CPR)	8	-32	%	19	%
		Default rate	—	-8	%	2	%
		Loss severity	20	-60	%	21	%

Loan purchase commitments, net (2)	1,710	MSR multiple	1.0	-5.3	x	3.5	x
		Pull-through rate	13	-100	%	72	%
		Whole loan spread to TBA price	\$2.25	-\$3.28		\$3.28	
		Whole loan spread to swap rate - fixed rate	90	-206	bps	204	bps
		Prepayment rate (annual CPR)	15	-15	%	15	%
		Whole loan spread to swap rate - hybrid	75	-140	bps	107	bps

The fair value of the loans held by consolidated Sequoia entities was based on the fair value of the ABS issued by (1) these entities, which we determined were more readily observable, in accordance with accounting guidance for collateralized financing entities.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

Determination of Fair Value

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

Residential loans at Redwood

Estimated fair values for residential loans are determined using models that incorporate various observable inputs, including pricing information from whole loan sales and securitizations. Certain significant inputs in these models are considered unobservable and are therefore Level 3 in nature. Pricing inputs obtained from market whole loan transaction activity include indicative spreads to indexed to be announced ("TBA") prices and indexed swap rates for fixed-rate loans and indexed swap rates for hybrid loans (Level 3). Pricing inputs obtained from market securitization activity include indicative spreads to indexed TBA prices for senior residential mortgage-backed securities ("RMBS") and indexed swap rates for subordinate RMBS, and credit support levels (Level 3). Other unobservable inputs also include assumed future prepayment rates. Observable inputs include benchmark interest rates, swap rates, and TBA prices. These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed, or credit support assumptions.

Residential loans at consolidated Sequoia entities

We have elected to account for the consolidated Sequoia securitization entities as collateralized financing entities ("CFEs") in accordance with GAAP. A CFE is a variable interest entity that holds financial assets and issues beneficial interests in those assets, and these beneficial interests have contractual recourse only to the related assets of the CFE. Accounting guidance for CFEs allow companies to elect to measure both the financial assets and financial liabilities of a CFE using the more observable of the fair value of the financial assets or fair value of the financial liabilities. Pursuant to this guidance, we use the fair value of the ABS issued by the Sequoia CFEs (which we determined to be more observable) to determine the fair value of the loans held at these entities, whereby the net assets we consolidate in our financial statements related to these entities represent the estimated fair value of our retained interests in the Sequoia CFEs.

Real estate securities

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

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at June 30, 2018, we received dealer price indications on 75% of our securities, representing 84% of our carrying value. In the aggregate, our internal valuations of the securities for which

we received dealer price indications were within 1% of the aggregate average dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

Derivative assets and liabilities

Our derivative instruments include swaps, swaptions, TBAs, financial futures, loan purchase commitments ("LPCs"), and forward sale commitments ("FSCs"). Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets. Fair values of TBAs and financial futures are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2).

LPC and FSC fair values for jumbo loans are estimated based on the estimated fair values of the underlying loans (as described in "Residential loans at Redwood" above). In addition, fair values for LPCs are estimated based on the probability that the mortgage loan will be purchased (the "Pull-through rate") (Level 3).

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

MSRs

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

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

FHLBC stock

Our Federal Home Loan Bank ("FHLB") member subsidiary is required to purchase Federal Home Loan Bank of Chicago ("FHLBC") stock under a borrowing agreement between our FHLB-member subsidiary and the FHLBC. Under this agreement, the stock is redeemable at face value, which represents the carrying value and fair value of the stock (Level 2).

Guarantee asset

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

Pledged collateral

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

Cash and cash equivalents

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

Restricted cash

Restricted cash primarily includes interest-earning cash balances related to risk-sharing transactions with the Agencies, cash held in association with borrowings from the FHLBC, and cash held at consolidated Sequoia entities for the purpose of distribution to investors and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values (Level 1).

Accrued interest receivable and payable

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

REO

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

Margin receivable

Margin receivable reflects cash collateral we have posted with our various derivative and debt counterparties as required to satisfy margin requirements. Fair values approximate carrying values (Level 2).

Short-term debt

Short-term debt includes our credit facilities that mature within one year. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 2). Additionally, at December 31, 2017, short-term debt included unsecured convertible senior notes with a maturity of less than one year. The fair value of the convertible notes is determined using quoted prices in generally active markets (Level 2).

ABS issued

ABS issued includes asset-backed securities issued through the Legacy Sequoia and Sequoia Choice securitization entities. These instruments are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. For ABS issued, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators factored into the analysis include bid/ask spreads, the amount and timing of collateral credit losses, interest rates, and collateral prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. A decrease in credit losses or discount rate, or an increase in prepayment rates, would generally cause the fair value of the ABS issued to decrease (i.e., become a larger liability).

FHLBC borrowings

FHLBC borrowings include amounts borrowed from the FHLBC that are secured, generally by residential mortgage loans. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 2).

Financial Instruments Carried at Amortized Cost

Participation in loan warehouse facility

Our participation in a loan warehouse facility is carried at amortized cost (Level 2).

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

Guarantee obligations

In association with our risk-sharing transactions with the Agencies, we have made certain guarantees which are carried on our balance sheet at amortized cost (Level 3).

Convertible notes

Convertible notes include unsecured convertible and exchangeable senior notes that are carried at their unpaid principal balance net of any unamortized deferred issuance costs (Level 2).

Trust preferred securities and subordinated notes

Trust preferred securities and subordinated notes are carried at their unpaid principal balance net of any unamortized deferred issuance costs (Level 3).

Note 6. Residential Loans

We acquire residential loans from third-party originators and may sell or securitize these loans or hold them for investment. The following table summarizes the classifications and carrying values of the residential loans owned at Redwood and at consolidated Sequoia entities at June 30, 2018 and December 31, 2017.

Table 6.1 – Classifications and Carrying Values of Residential Loans

June 30, 2018 (In Thousands)	Redwood	Legacy Sequoia	Sequoia Choice	Total
Held-for-sale				
At fair value	\$1,104,545	\$—	\$—	\$1,104,545
At lower of cost or fair value	115	—	—	115
Total held-for-sale	1,104,660	—	—	1,104,660
Held-for-investment at fair value	2,313,336	592,029	1,481,145	4,386,510
Total Residential Loans	\$3,417,996	\$592,029	\$1,481,145	\$5,491,170
December 31, 2017 (In Thousands)		Legacy Sequoia	Sequoia Choice	Total
Held-for-sale				
At fair value	\$1,427,052	\$—	\$—	\$1,427,052
At lower of cost or fair value	893	—	—	893
Total held-for-sale	1,427,945	—	—	1,427,945
Held-for-investment at fair value	2,434,386	632,817	620,062	3,687,265
Total Residential Loans	\$3,862,331	\$632,817	\$620,062	\$5,115,210

At June 30, 2018, we owned mortgage servicing rights associated with \$2.72 billion (principal balance) of consolidated residential loans purchased from third-party originators. The value of these MSR is included in the carrying value of the associated loans on our consolidated balance sheets. We contract with licensed sub-servicers that perform servicing functions for these loans.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 6. Residential Loans - (continued)

Residential Loans Held-for-Sale

At Fair Value

At June 30, 2018, we owned 1,547 loans held-for-sale at fair value with an aggregate unpaid principal balance of \$1.09 billion and a fair value of \$1.10 billion, compared to 2,009 loans with an aggregate unpaid principal balance of \$1.41 billion and a fair value of \$1.43 billion at December 31, 2017. At June 30, 2018, one of these loans with a fair value of \$0.6 million was greater than 90 days delinquent and none of these loans were in foreclosure. At December 31, 2017, one of these loans with a fair value of \$0.5 million was greater than 90 days delinquent and none of these loans were in foreclosure.

During the three and six months ended June 30, 2018, we purchased \$1.93 billion and \$3.73 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold \$1.92 billion and \$3.93 billion (principal balance) of loans, respectively, for which we recorded net market valuation gains of \$6 million and \$11 million, respectively, through Mortgage banking activities, net on our consolidated statements of income. At June 30, 2018, loans held-for-sale with a market value of \$786 million were pledged as collateral under short-term borrowing agreements.

During the three and six months ended June 30, 2017, we purchased \$1.20 billion and \$2.29 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold \$0.67 billion and \$2.04 billion (principal balance) of loans, respectively, for which we recorded net market valuation gains of \$6 million and \$14 million, respectively, through Mortgage banking activities, net on our consolidated statements of income.

At Lower of Cost or Fair Value

At June 30, 2018 and December 31, 2017, we held two and four residential loans, respectively, at the lower of cost or fair value with \$0.2 million and \$1 million in outstanding principal balance, respectively, and carrying values of \$0.1 million and \$1 million, respectively. At June 30, 2018, none of these loans were greater than 90 days delinquent or in foreclosure. At December 31, 2017, one of these loans with an unpaid principal balance of \$0.3 million was greater than 90 days delinquent and none of these loans were in foreclosure.

Residential Loans Held-for-Investment at Fair Value

At Redwood

At June 30, 2018, we owned 3,224 held-for-investment loans at Redwood with an aggregate unpaid principal balance of \$2.34 billion and a fair value of \$2.31 billion, compared to 3,292 loans with an aggregate unpaid principal balance of \$2.41 billion and a fair value of \$2.43 billion at December 31, 2017. At June 30, 2018, three of these loans with a total fair value of \$1 million were greater than 90 days delinquent and none of these loans were in foreclosure. At December 31, 2017, none of these loans were greater than 90 days delinquent or in foreclosure.

During the three and six months ended June 30, 2018, we transferred loans with a fair value of \$32 million and \$88 million, respectively, from held-for-sale to held-for-investment. During the three and six months ended June 30, 2018, we did not transfer loans from held-for-investment to held-for-sale. During the three and six months ended June 30, 2018, we recorded net market valuation losses of \$15 million and \$54 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net on our consolidated statements of income. At June 30, 2018, loans with a fair value of \$2.31 billion were pledged as collateral under a borrowing agreement with the FHLBC.

During the three and six months ended June 30, 2017, we transferred loans with a fair value of \$62 million and \$247 million, respectively, from held-for-sale to held-for-investment. During both the three and six months ended June 30, 2017, we transferred loans with a fair value of \$0.5 million from held-for-investment to held-for-sale. During the three and six months ended June 30, 2017, we recorded net market valuation gains of \$8 million and \$6 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net on our

consolidated statements of income.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018
 (Unaudited)

Note 6. Residential Loans - (continued)

At June 30, 2018, the outstanding loans held-for-investment at Redwood were prime-quality, first lien loans, of which 96% were originated between 2013 and 2018, and 4% were originated in 2012 and prior years. The weighted average FICO score of borrowers backing these loans was 770 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 66% (at origination). At June 30, 2018, these loans were comprised of 90% fixed-rate loans with a weighted average coupon of 4.08%, and the remainder were hybrid or ARM loans with a weighted average coupon of 4.09%.

At Consolidated Legacy Sequoia Entities

At June 30, 2018, we owned 2,924 held-for-investment loans at consolidated Legacy Sequoia entities, with an aggregate unpaid principal balance of \$623 million and a fair value of \$592 million, as compared to 3,178 loans at December 31, 2017, with an aggregate unpaid principal balance of \$698 million and a fair value of \$633 million. At origination, the weighted average FICO score of borrowers backing these loans was 728, the weighted average LTV ratio of these loans was 66%, and the loans were nearly all first lien and prime-quality.

At June 30, 2018 and December 31, 2017, the unpaid principal balance of loans at consolidated Legacy Sequoia entities delinquent greater than 90 days was \$18 million and \$25 million, respectively, of which the unpaid principal balance of loans in foreclosure was \$7 million and \$10 million, respectively. During the three and six months ended June 30, 2018, we recorded net market valuation gains of \$4 million and \$33 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income. During the three and six months ended June 30, 2017, we recorded net market valuation gains of \$11 million and \$19 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income. Pursuant to the collateralized financing entity guidelines, the market valuation changes of these loans are based on the estimated fair value of the associated ABS issued. The net impact to our income statement associated with our retained economic investment in the Legacy Sequoia securitization entities is presented in Note 5.

At Consolidated Sequoia Choice Entities

At June 30, 2018, we owned 1,990 held-for-investment loans at the consolidated Sequoia Choice entities, with an aggregate unpaid balance of \$1.46 billion and a fair value of \$1.48 billion, as compared to 806 loans at December 31, 2017 with an aggregate unpaid principal balance of \$605 million and a fair value of \$620 million. At origination, the weighted average FICO score of borrowers backing these loans was 743, the weighted average LTV ratio of these loans was 74%, and the loans were all first lien and prime-quality. At both June 30, 2018 and December 31, 2017, none of these loans were greater than 90 days delinquent or in foreclosure.

During the three and six months ended June 30, 2018, we transferred loans with a fair value of \$530 million and \$982 million, respectively, from held-for-sale to held-for-investment associated with Choice securitizations. Pursuant to the collateralized financing entity guidelines, the market valuation changes of these loans are based on the estimated fair value of the ABS issued associated with Choice securitizations. The net impact to our income statement associated with our retained economic investment in the Sequoia Choice securitization entities is presented in Note 5.

Note 7. Real Estate Securities

We invest in real estate securities that we acquire from third parties or create and retain from our Sequoia securitizations. The following table presents the fair values of our real estate securities by type at June 30, 2018 and December 31, 2017.

Table 7.1 – Fair Values of Real Estate Securities by Type

(In Thousands)	June 30, 2018	December 31, 2017
Trading	\$1,054,295	\$ 968,844
Available-for-sale	399,641	507,666

Total Real Estate Securities \$1,453,936 \$ 1,476,510

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REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018

(Unaudited)

Note 7. Real Estate Securities - (continued)

Our real estate securities include mortgage-backed securities, which are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally have the first right to cash flows and are last in line to absorb losses. Mezzanine securities are interests that are generally subordinate to senior securities in their rights to receive cash flows, and have subordinate securities below them that are first to absorb losses. Our mezzanine classified securities were initially rated AA through BBB- and issued in 2012 or later. Subordinate securities are all interests below mezzanine. Nearly all of our residential securities are supported by collateral that was designated as prime at the time of issuance.

Trading Securities

The following table presents the fair value of trading securities by position and collateral type at June 30, 2018 and December 31, 2017.

Table 7.2 – Trading Securities by Position and Collateral Type

(In Thousands)	June 30, 2018	December 31, 2017
Senior	\$ 138,329	\$ 69,974
Mezzanine	600,629	563,475
Subordinate	315,337	335,395
Total Trading Securities	\$ 1,054,295	\$ 968,844

We elected the fair value option for certain securities and classify them as trading securities. Our trading securities include both residential and commercial/multifamily securities. At June 30, 2018, trading securities with a carrying value of \$613 million as well as \$88 million of securities retained from our consolidated Sequoia Choice securitizations were pledged as collateral under short-term borrowing agreements. See Note 10 for additional information on short-term debt.

At June 30, 2018 and December 31, 2017, our senior trading securities included \$89 million and \$70 million of interest-only securities, respectively, for which there is no principal balance, and the remaining unpaid principal balance of our senior trading securities was \$50 million and zero, respectively. Our interest-only securities included \$39 million and \$15 million of A-IO-S securities at June 30, 2018 and December 31, 2017, respectively, which are securities we retained from certain of our Sequoia securitizations that represent certificated servicing strips.

At June 30, 2018 and December 31, 2017, our mezzanine and subordinate trading securities had an unpaid principal balance of \$1.01 billion and \$943 million, respectively, and included \$240 million and \$301 million, respectively, of Agency residential mortgage credit risk transfer (or "CRT") securities, \$68 million and \$68 million, respectively, of Sequoia securities, \$209 million and \$206 million, respectively, of other third-party residential securities, and \$399 million and \$324 million, respectively, of third-party commercial/multifamily securities.

During the three and six months ended June 30, 2018, we acquired \$233 million and \$378 million (principal balance), respectively, of securities for which we elected the fair value option and classified as trading, and sold \$62 million and \$244 million, respectively, of such securities. During the three and six months ended June 30, 2017, we acquired \$107 million and \$261 million (principal balance), respectively, of securities for which we elected the fair value option and classified as trading, and sold \$51 million and \$60 million, respectively, of such securities.

During the three and six months ended June 30, 2018, we recorded net market valuation losses of \$1 million and \$4 million, respectively, on trading securities, included in Investment fair value changes, net and Mortgage banking activities, net on our consolidated statements of income. During the three and six months ended June 30, 2017, we recorded net market valuation gains of \$19 million and \$30 million, respectively, on trading securities, included in Investment fair value changes, net and Mortgage banking activities, net on our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 7. Real Estate Securities - (continued)

AFS Securities

The following table presents the fair value of our available-for-sale securities by position and collateral type at June 30, 2018 and December 31, 2017.

Table 7.3 – Available-for-Sale Securities by Position and Collateral Type

(In Thousands)	June 30, 2018	December 31, 2017
Senior ⁽¹⁾	\$ 147,490	\$ 179,864
Mezzanine	37,263	92,002
Subordinate	214,888	235,800
Total AFS Securities	\$ 399,641	\$ 507,666

Includes \$34 million and \$39 million of re-REMIC securities at June 30, 2018 and December 31, 2017, respectively. Re-REMIC securities were created through the resecuritization of certain senior security interests to (1) provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior security interests, but senior to any subordinate tranches of the securitization from which they were created.

At June 30, 2018 and December 31, 2017, all of our available-for-sale securities were comprised of residential mortgage-backed securities. At June 30, 2018, AFS securities with a carrying value of \$145 million were pledged as collateral under short-term borrowing agreements. See Note 10 for additional information on short-term debt. During the three and six months ended June 30, 2018, we purchased \$2 million and \$6 million of AFS securities, respectively, and sold \$41 million and \$92 million of AFS securities, respectively, which resulted in net realized gains of \$5 million and \$14 million, respectively. During the three and six months ended June 30, 2017, we purchased \$2 million and \$27 million of AFS securities, respectively, and sold \$19 million and \$38 million of AFS securities, respectively, which resulted in net realized gains of \$3 million and \$8 million, respectively.

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

At June 30, 2018, there were less than \$0.1 million of AFS securities with contractual maturities less than five years, \$2 million with contractual maturities greater than five years but less than 10 years, and the remainder of our AFS securities had contractual maturities greater than 10 years.

The following table presents the components of carrying value (which equals fair value) of AFS securities at June 30, 2018 and December 31, 2017.

Table 7.4 – Carrying Value of AFS Securities

June 30, 2018

(In Thousands)	Senior	Mezzanine	Subordinate	Total
Principal balance	\$ 152,651	\$ 38,036	\$ 312,983	\$ 503,670
Credit reserve	(8,187)	—	(34,004)	(42,191)
Unamortized discount, net	(34,376)	(3,993)	(131,721)	(170,090)
Amortized cost	110,088	34,043	147,258	291,389
Gross unrealized gains	38,153	3,220	68,236	109,609

Gross unrealized losses	(751)	—	(606)	(1,357)
Carrying Value	\$147,490	\$37,263	\$214,888	\$399,641

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 7. Real Estate Securities - (continued)

December 31, 2017

(In Thousands)	Senior	Mezzanine	Subordinate	Total
Principal balance	\$189,125	\$91,471	\$327,549	\$608,145
Credit reserve	(8,756)	—	(37,793)	(46,549)
Unamortized discount, net	(44,041)	(9,407)	(130,305)	(183,753)
Amortized cost	136,328	82,064	159,451	377,843
Gross unrealized gains	44,771	9,938	76,481	131,190
Gross unrealized losses	(1,235)	—	(132)	(1,367)
Carrying Value	\$179,864	\$92,002	\$235,800	\$507,666

The following table presents the changes for the three and six months ended June 30, 2018, in unamortized discount and designated credit reserves on residential AFS securities.

Table 7.5 – Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

(In Thousands)	Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
	Credit Reserve	Unamortized Discount, Net	Credit Reserve	Unamortized Discount, Net
Beginning balance	\$40,616	\$178,302	\$46,549	\$183,753
Amortization of net discount	—	(3,848)	—	(7,908)
Realized credit losses	(385)	—	(1,341)	—
Acquisitions	2,251	495	4,787	2,130
Sales, calls, other	(299)	(4,907)	(1,066)	(14,679)
Impairments	56	—	56	—
(Release of) transfers to credit reserves, net	(48)	48	(6,794)	6,794
Ending Balance	\$42,191	\$170,090	\$42,191	\$170,090

AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at June 30, 2018 and December 31, 2017.

Table 7.6 – Components of Fair Value of Residential AFS Securities by Holding Periods

(In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Amortize Cost	Unrealized Losses	Fair Value	Amortize Cost	Unrealized Losses	Fair Value
June 30, 2018	\$18,610	\$ (606)	\$18,004	\$25,887	\$ (751)	\$25,136
December 31, 2017	8,637	(132)	8,505	28,557	(1,235)	27,322

At June 30, 2018, after giving effect to purchases, sales, and extinguishment due to credit losses, our consolidated balance sheet included 145 AFS securities, of which 10 were in an unrealized loss position and three were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2017, our consolidated balance sheet included 167 AFS securities, of which nine were in an unrealized loss position and three were in a continuous unrealized loss position for 12 consecutive months or longer.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 7. Real Estate Securities - (continued)

Evaluating AFS Securities for Other-than-Temporary Impairments

Gross unrealized losses on our AFS securities were \$1 million at June 30, 2018. We evaluate all securities in an unrealized loss position to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). At June 30, 2018, we did not intend to sell any of our AFS securities that were in an unrealized loss position, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity. We review our AFS securities that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent security performance and expected future performance of the underlying collateral. For the three and six months ended June 30, 2018, other-than-temporary impairments were \$0.3 million, of which \$0.1 million were recognized through our consolidated statements of income and \$0.2 million were recognized in Accumulated other comprehensive income, a component of our consolidated balance sheet. AFS securities for which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. In determining our estimate of cash flows for AFS securities we may consider factors such as structural credit enhancement, past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, which are informed by prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, and geographic concentrations, as well as general market assessments. Changes in our evaluation of these factors impacted the cash flows expected to be collected at the OTTI assessment date and were used to determine if there were credit-related adverse cash flows and if so, the amount of credit related losses. Significant judgment is used in both our analysis of the expected cash flows for our AFS securities and any determination of the credit loss component of OTTI. The table below summarizes the significant valuation assumptions we used for our AFS securities in unrealized loss positions at June 30, 2018.

Table 7.7 – Significant Valuation Assumptions

June 30, 2018	Range for Securities
Prepayment rates	6% - 10%
Projected losses	0.20% - 3%

The following table details the activity related to the credit loss component of OTTI (i.e., OTTI recognized through earnings) for AFS securities held at June 30, 2018 and 2017, for which a portion of an OTTI was recognized in other comprehensive income.

Table 7.8 – Activity of the Credit Component of Other-than-Temporary Impairments

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Balance at beginning of period	\$20,924	\$26,390	\$21,037	\$28,261
Additions				
Initial credit impairments	43	81	43	178
Subsequent credit impairments	—	47	—	47
Reductions				
Securities sold, or expected to sell	—	(716)	(99)	(2,282)
Securities with no outstanding principal at period end	—	—	(14)	(402)
Balance at End of Period	\$20,967	\$25,802	\$20,967	\$25,802

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 7. Real Estate Securities - (continued)

Gains and losses from the sale of AFS securities are recorded as Realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains and losses on sales and calls of AFS securities for the three and six months ended June 30, 2018 and 2017.

Table 7.9 – Gross Realized Gains and Losses on AFS Securities

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Gross realized gains - sales	\$4,674	\$2,555	\$14,037	\$7,647
Gross realized gains - calls	43	66	43	677
Gross realized losses - sales	(3)	—	(3)	—
Gross realized losses - calls	—	(497)	—	(497)
Total Realized Gains on Sales and Calls of AFS Securities, net	\$4,714	\$2,124	\$14,077	\$7,827

Note 8. Derivative Financial Instruments

The following table presents the fair value and notional amount of our derivative financial instruments at June 30, 2018 and December 31, 2017.

Table 8.1 – Fair Value and Notional Amount of Derivative Financial Instruments

(In Thousands)	June 30, 2018		December 31, 2017	
	Fair Value	Notional Amount	Fair Value	Notional Amount
Assets - Risk Management Derivatives				
Interest rate swaps	\$59,468	\$2,675,500	\$10,122	\$1,765,000
TBAs	3,186	1,230,000	133	295,000
Futures	—	—	1	7,500
Swaptions	—	—	42	200,000
Assets - Other Derivatives				
Loan purchase commitments	2,991	460,620	3,243	547,434
Loan forward sale commitments	—	—	2,177	343,681
Total Assets	\$65,645	\$4,366,120	\$15,718	\$3,158,615
Liabilities - Cash Flow Hedges				
Interest rate swaps	\$(31,601)	\$139,500	\$(43,679)	\$139,500
Liabilities - Risk Management Derivatives				
Interest rate swaps	(13,129)	820,000	(11,888)	1,248,000
TBAs	(6,372)	1,485,000	(3,808)	1,400,000
Futures	(126)	15,000	—	—
Liabilities - Other Derivatives				
Loan purchase commitments	(4,701)	805,139	(3,706)	697,966
Total Liabilities	\$(55,929)	\$3,264,639	\$(63,081)	\$3,485,466
Total Derivative Financial Instruments, Net	\$9,716	\$7,630,759	\$(47,363)	\$6,644,081

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 8. Derivative Financial Instruments - (continued)

Risk Management Derivatives

To manage, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheets, we may enter into derivative contracts. At June 30, 2018, we were party to swaps and swaptions with an aggregate notional amount of \$3.50 billion, TBA agreements sold with an aggregate notional amount of \$2.72 billion, and financial futures contracts with an aggregate notional amount of \$15 million. At December 31, 2017, we were party to swaps and swaptions with an aggregate notional amount of \$3.21 billion, TBA agreements sold with an aggregate notional amount of \$1.70 billion, and financial futures contracts with an aggregate notional amount of \$8 million. During the three and six months ended June 30, 2018, risk management derivatives had net market valuation gains of \$22 million and \$89 million, respectively. During the three and six months ended June 30, 2017, risk management derivatives had net market valuation losses of \$20 million and \$27 million, respectively. These market valuation gains and losses are recorded in Mortgage banking activities, net, Investment fair value changes, net, and Other income, net on our consolidated statements of income.

Loan Purchase and Forward Sale Commitments

LPCs and FSCs that qualify as derivatives are recorded at their estimated fair values. For the three and six months ended June 30, 2018, LPCs and FSCs had net market valuation losses of \$3 million and \$10 million, respectively, that were recorded in Mortgage banking activities, net on our consolidated statements of income. For the three and six months ended June 30, 2017, LPCs had net market valuation gains of \$10 million and \$21 million, respectively, that were recorded in Mortgage banking activities, net on our consolidated statements of income.

Derivatives Designated as Cash Flow Hedges

To manage the variability in interest expense related to portions of our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated certain interest rate swaps as cash flow hedges with an aggregate notional balance of \$140 million. For the three and six months ended June 30, 2018, changes in the values of designated cash flow hedges were positive \$3 million and positive \$12 million, respectively, and were recorded in Accumulated other comprehensive income, a component of equity. For the three and six months ended June 30, 2017, changes in the values of designated cash flow hedges were negative \$2 million and negative \$1 million, respectively, and were recorded in Accumulated other comprehensive income, a component of equity. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in Accumulated other comprehensive income was \$31 million and \$43 million at June 30, 2018 and December 31, 2017, respectively.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and six months ended June 30, 2018 and 2017.

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net interest expense on cash flows hedges	\$ (804)	\$ (1,172)	\$ (1,802)	\$ (2,397)
Realized net losses reclassified from other comprehensive income	—	(14)	—	(28)
Total Interest Expense	\$ (804)	\$ (1,186)	\$ (1,802)	\$ (2,425)

Derivative Counterparty Credit Risk

As discussed in our Annual Report on Form 10-K for the year ended December 31, 2017, we consider counterparty risk as part of our fair value assessments of all derivative financial instruments at each quarter-end. At June 30, 2018, we assessed this risk as remote and did not record a specific valuation adjustment.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 8. Derivative Financial Instruments - (continued)

At June 30, 2018, we had outstanding derivative agreements with two counterparties (other than clearinghouses) and were in compliance with ISDA agreements governing our open derivative positions.

Note 9. Other Assets and Liabilities

Other assets at June 30, 2018 and December 31, 2017, are summarized in the following table.

Table 9.1 – Components of Other Assets

(In Thousands)	June 30, 2018	December 31, 2017
Mortgage servicing rights	\$64,674	\$ 63,598
Margin receivable	49,538	85,044
FHLBC stock	43,393	43,393
Pledged collateral	42,201	42,615
Participation in loan warehouse facility	41,658	—
Investment in 5 Arches	10,973	—
Fixed assets and leasehold improvements ⁽¹⁾	5,189	2,645
Guarantee asset	2,936	2,869
REO	2,649	3,354
Other	9,459	15,046
Total Other Assets	\$272,670	\$ 258,564

⁽¹⁾ Fixed assets and leasehold improvements had a basis of \$10 million and accumulated depreciation of \$4 million at June 30, 2018.

Accrued expenses and other liabilities at June 30, 2018 and December 31, 2017 are summarized in the following table.

Table 9.2 – Components of Accrued Expenses and Other Liabilities

(In Thousands)	June 30, 2018	December 31, 2017
Guarantee obligations	\$18,124	\$ 19,487
Accrued compensation	13,387	24,025
Deferred tax liabilities	11,764	11,764
Unsettled trades	11,328	13
Margin payable	7,282	390
Residential loan and MSR repurchase reserve	4,443	4,916
Accrued income taxes payable	2,547	—
Legal reserve	2,000	2,000
Other	8,696	5,134
Total Accrued Expenses and Other Liabilities	\$79,571	\$ 67,729

Mortgage Servicing Rights

We invest in mortgage servicing rights associated with residential mortgage loans and contract with licensed sub-servicers to perform all servicing functions for these loans. The majority of our investments in MSRs were made through the retention of servicing rights associated with the residential jumbo mortgage loans that we acquire and subsequently transfer to third parties. We hold our MSR investments at our taxable REIT subsidiary.

At June 30, 2018 and December 31, 2017, our MSRs had a fair value of \$65 million and \$64 million, respectively, and were associated with loans with an aggregate principal balance of \$5.16 billion and \$5.56 billion, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 9. Other Assets and Liabilities - (continued)

The following table presents activity for MSR for the three and six months ended June 30, 2018 and 2017.
 Table 9.3 – Activity for MSRs

(In Thousands)	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2018	2017	2018	2017
Balance at beginning of period	\$66,496	\$111,013	\$63,598	\$118,526
Additions	—	216	—	7,701
Sales	(1,077)	(41,038)	(1,077)	(52,966)
Changes in fair value due to:				
Changes in assumptions ⁽¹⁾	943	(3,356)	5,289	(4,013)
Other changes ⁽²⁾	(1,688)	(3,065)	(3,136)	(5,478)
Balance at End of Period	\$64,674	\$63,770	\$64,674	\$63,770

(1) Primarily reflects changes in prepayment assumptions due to changes in market interest rates.

(2) Represents changes due to the realization of expected cash flows.

The following table presents the components of our MSR income for the three and six months ended June 30, 2018 and 2017.

Table 9.4 – Components of MSR Income, net

(In Thousands)	Three Months		Six Months Ended	
	Ended June 30,	Ended June 30,	June 30,	June 30,
	2018	2017	2018	2017
Servicing income	\$3,802	\$6,511	\$7,597	\$13,418
Cost of sub-servicer	(338)	(659)	(930)	(2,039)
Net servicing fee income	3,464	5,852	6,667	11,379
Market valuation changes of MSRs	(745)	(6,421)	2,147	(9,491)
Market valuation changes of associated derivatives	(1,122)	3,040	(6,261)	2,291
MSR reversal of provision for repurchases	277	307	277	312
MSR Income, Net ⁽¹⁾	\$1,874	\$2,778	\$2,830	\$4,491

(1) MSR income, net is included in Other income, net on our consolidated statements of income.

Margin Receivable and Payable

Margin receivable and payable resulted from margin calls between us and our counterparties under derivatives, master repurchase agreements, and warehouse facilities, whereby we or the counterparty posted collateral.

FHLB Stock

In accordance with our FHLB-member subsidiary's borrowing agreement with the FHLBC, our subsidiary is required to purchase and hold stock in the FHLBC. See Note 3 and Note 12 for additional information on this borrowing agreement.

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Note 9. Other Assets and Liabilities - (continued)

Participation in Loan Warehouse Facility

In the second quarter of 2018, we invested in a subordinated participation in a revolving mortgage loan warehouse credit facility of one of our loan sellers. While our interest is subordinated, it is secured by the loans collateralizing the facility and we have recourse to the loan seller. We account for this subordinated participation interest as a loan receivable at amortized cost, and all associated interest income is recorded as a component of Other interest income in our consolidated statements of income. We monitor the credit quality of the warehouse line of credit and utilize such information in our evaluation of the appropriateness of the allowance for credit losses. As of June 30, 2018, we determined no allowance for credit losses was required for this receivable.

Investment in 5 Arches

On May 1, 2018, we acquired a 20% minority interest in 5 Arches, LLC ("5 Arches") for \$10 million, which included a one-year option to purchase all remaining equity in the company for a combination of cash and stock totaling \$40 million. 5 Arches is an originator and asset manager of business-purpose residential mortgage loans, including loans to investors in single-family rental properties, bridge loans for investors in multifamily properties, and loans to investors rehabilitating and reselling residential properties. In connection with this investment, we also entered into a loan flow purchase agreement, which gives us exclusive access to 5 Arches' single-family rental loan production for a one-year period. At June 30, 2018, we had not purchased any loans under this agreement.

We account for our ownership interest in 5 Arches using the equity method of accounting as we are able to exert significant influence over but do not control the activities of the investee. At June 30, 2018, the carrying amount of our investment in 5 Arches was \$7 million. We account for our purchase option as a cost method investment, which had a carrying value of \$4 million at June 30, 2018. We have elected to record our share of earnings or losses from 5 Arches on a one-quarter lag, and as such, we did not record any equity method investment earnings or losses associated with this investment during the three months ended June 30, 2018.

Guarantee Asset, Pledged Collateral, and Guarantee Obligations

The pledged collateral, guarantee asset, and guarantee obligations presented in the tables above are related to our risk-sharing arrangements with Fannie Mae and Freddie Mac. In accordance with these arrangements, we are required to pledge collateral to secure our guarantee obligations. See Note 13 for additional information on our risk-sharing arrangements.

REO

The carrying value of REO at June 30, 2018 was \$3 million, which includes the net effect of \$2 million related to transfers into REO during the six months ended June 30, 2018, offset by \$3 million of REO liquidations, and \$0.4 million of unrealized gains resulting from market valuation adjustments. At June 30, 2018 and December 31, 2017, there were 9 and 14 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Legacy Sequoia entities.

Legal and Repurchase Reserves

See Note 13 for additional information on the legal and residential repurchase reserves.

Note 10. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At June 30, 2018, we had outstanding agreements with several counterparties and we were in compliance with all of the related covenants. For additional information about these financial covenants and our short-term debt, see Part I, Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q and Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2017.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 10. Short-Term Debt - (continued)

The table below summarizes our short-term debt, including the facilities that are available to us, the outstanding balances, the weighted average interest rate, and the maturity information at June 30, 2018 and December 31, 2017.
Table 10.1 – Short-Term Debt

		June 30, 2018						
(Dollars in Thousands)	Number of Facilities	Outstanding Balance	Limit	Weighted Average Interest Rate	Maturity	Weighted Average Days Until Maturity		
Facilities								
Residential loan warehouse	4	\$719,394	\$1,425,000	3.69 %	8/2018-3/2019	141		
Real estate securities repo	7	706,894	—	3.25 %	7/2018-9/2018	28		
Total Short-Term Debt	11	\$1,426,288						
		December 31, 2017						
(Dollars in Thousands)	Number of Facilities	Outstanding Balance	Limit	Weighted Average Interest Rate	Maturity	Weighted Average Days Until Maturity		
Facilities								
Residential loan warehouse	4	\$1,039,666	\$1,575,000	3.17 %	1/2018-12/2018	197		
Real estate securities repo	9	648,746	—	2.69 %	1/2018-3/2018	28		
Total Short-Term Debt	13	1,688,412						
Facilities								
Convertible notes, net	N/A	250,270	—	4.63 %	4/2018	105		
Total Short-Term Debt		\$1,938,682						

Borrowings under our facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At June 30, 2018, all of these borrowings were under uncommitted facilities and were due within 364 days (or less) of the borrowing date.

The fair value of held-for-sale residential loans and real estate securities pledged as collateral under our short-term debt facilities was \$786 million and \$846 million, respectively, at June 30, 2018 and \$1.15 billion and \$788 million, respectively, at December 31, 2017. At June 30, 2018, the fair value of our real estate securities pledged as collateral included \$88 million of securities retained from our consolidated Sequoia Choice securitizations. For the three and six months ended June 30, 2018, the average balances of our short-term debt facilities were \$1.48 billion and \$1.42 billion, respectively. At June 30, 2018 and December 31, 2017, accrued interest payable on our short-term debt facilities was \$3 million and \$2 million, respectively.

During the second quarter of 2017, \$288 million principal amount of 4.625% convertible senior notes and \$2 million of unamortized deferred issuance costs were reclassified from long-term debt to short-term debt, as the maturity of the notes was less than one year as of April 2017. Additionally, during the second quarter of 2017, we repurchased \$37 million par value of these notes at a premium and recorded a loss on extinguishment of debt of \$1 million in Realized gains, net on our consolidated statements of income. In April 2018, we repaid these \$250 million convertible notes and all related accrued interest in full. See Note 12 for additional information on our convertible notes.

We also maintain a \$10 million committed line of credit with a financial institution that is secured by certain mortgage-backed securities with a fair market value of \$4 million at June 30, 2018. At both June 30, 2018 and

December 31, 2017, we had no outstanding borrowings on this facility.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 10. Short-Term Debt - (continued)

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of our secured short-term debt by the type of collateral securing the debt at June 30, 2018.

Table 10.2 – Short-Term Debt by Collateral Type and Remaining Maturities

(In Thousands)	June 30, 2018			
	Within 30 days	31 to 90 days	Over 90 days	Total
Collateral Type				
Held-for-sale residential loans	\$—	\$334,775	\$384,619	\$719,394
Real estate securities	491,738	215,156	—	706,894
Total Short-Term Debt	\$491,738	\$549,931	\$384,619	\$1,426,288

Note 11. Asset-Backed Securities Issued

Through our Sequoia securitization program, we sponsor securitization transactions in which ABS backed by residential mortgage loans are issued by Sequoia entities. We consolidated the Legacy Sequoia securitization entities, and beginning in September 2017, the Sequoia Choice securitization entities, that we determined were VIEs and for which we determined we were the primary beneficiary. Each consolidated securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, servicing administrator, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

We account for the ABS issued under our consolidated Sequoia entities at fair value, with periodic changes in fair value recorded in Investment fair value changes, net on our consolidated statements of income. Pursuant to the CFE guidelines, the market valuation changes on our Sequoia loans are based on the estimated fair value of the associated ABS issued. The net impact to our income statement associated with our retained economic investment in the Sequoia securitization entities is presented in Note 5.

The ABS issued by these entities consist of various classes of securities that pay interest on a monthly or quarterly basis. All ABS issued by the Sequoia Choice entities pay fixed rates of interest and substantially all ABS issued by the Legacy Sequoia entities pay variable rates of interest, which are indexed to one-, three-, or six-month LIBOR. ABS issued also includes some interest-only classes with coupons set at a fixed spread to a benchmark rate, or set at a spread to the interest rates earned on the assets less the interest rates paid on the liabilities of a securitization entity.

The carrying values of ABS issued by Sequoia securitization entities we sponsored at June 30, 2018 and December 31, 2017, along with other selected information, are summarized in the following table.

Table 11.1 – Asset-Backed Securities Issued

June 30, 2018	Legacy Sequoia	Sequoia Choice	Total
(Dollars in Thousands)			
Certificates with principal balance	\$615,868	\$1,320,414	\$1,936,282
Interest-only certificates	1,578	21,843	23,421
Market valuation adjustments	(35,211)	5,170	(30,041)
ABS Issued, Net	\$582,235	\$1,347,427	\$1,929,662
Range of weighted average interest rates, by series	2.12% to 3.26%	4.48% to 4.65%	
Stated maturities			

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	2024 -	2047 -
	2036	2048
Number of series	20	4

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

December 31, 2017 (Dollars in Thousands)	Legacy Sequoia	Sequoia Choice	Total
Certificates with principal balance	\$691,125	\$526,657	\$1,217,782
Interest-only certificates	1,972	7,695	9,667
Market valuation adjustments	(70,652)	7,788	(62,864)
ABS Issued, Net	\$622,445	\$542,140	\$1,164,585
Range of weighted average interest rates, by series	1.46% to 2.78%	4.52% to 4.73%	
Stated maturities	2024 - 2036	2047	
Number of series	20	2	

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its stated maturity. At June 30, 2018, all of the ABS issued and outstanding had contractual maturities beyond five years.

At both June 30, 2018 and December 31, 2017, accrued interest payable on ABS issued by the Legacy Sequoia entities was \$1 million. At June 30, 2018 and December 31, 2017, accrued interest payable on ABS issued by the Sequoia Choice entities was \$5 million and \$2 million, respectively. Interest due on consolidated ABS issued is payable monthly.

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at June 30, 2018 and December 31, 2017.

Table 11.2 – Collateral for Asset-Backed Securities Issued			
June 30, 2018 (In Thousands)	Legacy Sequoia	Sequoia Choice	Total
Residential loans	\$592,029	\$1,481,145	\$2,073,174
Restricted cash	147	10	157
Accrued interest receivable	835	5,956	6,791
REO	2,649	—	2,649
Total Collateral for ABS Issued	\$595,660	\$1,487,111	\$2,082,771
December 31, 2017 (In Thousands)	Legacy Sequoia	Sequoia Choice	Total
Residential loans	\$632,817	\$620,062	\$1,252,879
Restricted cash	147	4	151
Accrued interest receivable	867	2,524	3,391
REO	3,353	—	3,353
Total Collateral for ABS Issued	\$637,184	\$622,590	\$1,259,774

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 12. Long-Term Debt

FHLBC Borrowings

In July 2014, our FHLB-member subsidiary entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. At June 30, 2018, under this agreement, our subsidiary could incur borrowings up to \$2.00 billion, also referred to as “advances,” from the FHLBC secured by eligible collateral, including residential mortgage loans. During the three and six months ended June 30, 2018, our FHLB-member subsidiary made no additional borrowings under this agreement. Under a final rule published by the Federal Housing Finance Agency in January 2016, our FHLB-member subsidiary will remain an FHLB member through the five-year transition period for captive insurance companies. Our FHLB-member subsidiary's existing \$2.00 billion of FHLB debt, which matures beyond this transition period, is permitted to remain outstanding until its stated maturity. As residential loans pledged as collateral for this debt pay down, we are permitted to pledge additional loans or other eligible assets to collateralize this debt; however, we do not expect to be able to increase our subsidiary's FHLB debt above the existing \$2.00 billion maximum.

At June 30, 2018, \$2.00 billion of advances were outstanding under this agreement, which were classified as long-term debt, with a weighted average interest rate of 2.03% and a weighted average maturity of approximately seven years. At December 31, 2017, \$2.00 billion of advances were outstanding under this agreement, which were classified as long-term debt, with a weighted average interest rate of 1.38% and a weighted average maturity of eight years. Advances under this agreement incur interest charges based on a specified margin over the FHLBC's 13-week discount note rate, which resets every 13 weeks. Total advances under this agreement were secured by residential mortgage loans with a fair value of \$2.31 billion at June 30, 2018. This agreement also requires our subsidiary to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of outstanding advances. At June 30, 2018, our subsidiary held \$43 million of FHLBC stock that is included in Other assets in our consolidated balance sheets.

The following table presents maturities of our FHLBC borrowings by year at June 30, 2018.

Table 12.1 – Maturities of FHLBC Borrowings by Year

(In Thousands)	June 30, 2018
2024	\$470,171
2025	887,639
2026	642,189
Total FHLBC Borrowings	\$1,999,999

For additional information about our FHLBC borrowings, see Part I, Item 2 of Quarterly Report on Form 10-Q under the heading “Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities.”

Convertible Notes

In June 2018, we issued \$200 million principal amount of 5.625% convertible senior notes due 2024 at an issuance price of 99.5%. These convertible notes require semi-annual interest payments at a fixed coupon rate of 5.625% until maturity or conversion, which will be no later than July 15, 2024. After deducting the issuance discount, the underwriting discount and offering costs, we received \$194 million of net proceeds. Including amortization of deferred debt issuance costs and the debt discount, the weighted average interest expense yield on these convertible notes is approximately 6.2% per annum. These notes are convertible at the option of the holder at a conversion rate of 54.7645 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of \$18.26 per common share). Upon conversion of these notes by a holder, the holder will receive shares of our common

stock. At June 30, 2018, the outstanding principal amount of these notes was \$200 million and the accrued interest payable on this debt was \$0.2 million. At June 30, 2018, the unamortized deferred issuance costs and debt discount were \$5 million and \$1 million, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 12. Long-Term Debt - (continued)

In August 2017, we issued \$245 million principal amount of 4.75% convertible senior notes due 2023. These convertible notes require semi-annual interest payments at a fixed coupon rate of 4.75% until maturity or conversion, which will be no later than August 15, 2023. After deducting the underwriting discount and offering costs, we received \$238 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these convertible notes is approximately 5.3% per annum. At June 30, 2018, these notes were convertible at the option of the holder at a conversion rate of 53.9060 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of \$18.55 per common share). Upon conversion of these notes by a holder, the holder will receive shares of our common stock. At June 30, 2018, the outstanding principal amount of these notes was \$245 million. At June 30, 2018, the accrued interest payable balance on this debt was \$4 million and the unamortized deferred issuance costs were \$6 million.

In November 2014, RWT Holdings, Inc., a wholly-owned subsidiary of Redwood Trust, Inc., issued \$205 million principal amount of 5.625% exchangeable senior notes due 2019. These exchangeable notes require semi-annual interest payments at a fixed coupon rate of 5.625% until maturity or exchange, which will be no later than November 15, 2019. After deducting the underwriting discount and offering costs, we received \$198 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these exchangeable notes is approximately 6.3% per annum. At June 30, 2018, these notes were convertible at the option of the holder at a conversion rate of 46.2370 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of \$21.63 per common share). Upon exchange of these notes by a holder, the holder will receive shares of our common stock. During the first quarter of 2016, we repurchased \$4 million par value of these notes at a discount and recorded a gain on extinguishment of debt of \$0.3 million in Realized gains, net on our consolidated statements of income. At June 30, 2018, the outstanding principal amount of these notes was \$201 million. At June 30, 2018, the accrued interest payable balance on this debt was \$1 million and the unamortized deferred issuance costs were \$2 million.

In March 2013, we issued \$288 million principal amount of 4.625% convertible senior notes due in April 2018. These convertible notes required semi-annual interest payments at a fixed coupon rate of 4.625% until the debt matured on April 15, 2018. After deducting the underwriting discount and offering costs, we received \$279 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these convertible notes was approximately 4.8% per annum. Until maturity, these notes were convertible at the option of the holder at a conversion rate of 41.1320 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of \$24.31 per common share). During the second quarter of 2017, \$288 million principal amount of these convertible notes and \$2 million of unamortized deferred issuance costs were reclassified from long-term debt to short-term debt, as the maturity of the notes was less than one year as of April 2017. Additionally, during the second quarter of 2017, we repurchased \$37 million par value of these notes at a premium and recorded a loss on extinguishment of debt of \$1 million in Realized gains, net on our consolidated statements of income. In April 2018, we repaid these \$250 million convertible notes and all related accrued interest in full.

Trust Preferred Securities and Subordinated Notes

At June 30, 2018, we had trust preferred securities and subordinated notes outstanding of \$100 million and \$40 million, respectively. This debt requires quarterly interest payments at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed. The \$100 million trust preferred securities will be redeemed no later than January 30, 2037, and the \$40 million subordinated notes will be redeemed no later than July 30, 2037. Prior to 2014, we entered into interest rate swaps with aggregate notional values totaling \$140 million to hedge the variability in this long-term debt interest expense. Including hedging costs and amortization of deferred debt issuance costs, the weighted average interest expense yield on our trust preferred securities and subordinated notes is approximately 6.8%

per annum. At both June 30, 2018 and December 31, 2017, the accrued interest payable balance on our trust preferred securities and subordinated notes was \$1 million.

Under the terms of this debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is pari passu or subordinate to this debt.

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Note 12. Long-Term Debt - (continued)

Single-Family Rental Loan Warehouse Facilities

During the second quarter of 2018, we entered into repurchase facilities with two third-party financial institutions to finance purchases of mortgage loans secured by 1-4 unit residential rental real estate ("single-family rental loans"). The first facility has an aggregate maximum borrowing capacity of \$200 million and is scheduled to mature on June 29, 2020. The second facility has an aggregate maximum borrowing capacity of \$200 million and is scheduled to mature on June 29, 2021. Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At June 30, 2018, there were no amounts outstanding under either of these facilities.

Note 13. Commitments and Contingencies

Lease Commitments

At June 30, 2018, we were obligated under four non-cancelable operating leases with expiration dates through 2028 for \$17 million of cumulative lease payments. Our operating lease expense was \$1 million for both six-month periods ended June 30, 2018 and 2017.

The following table presents our future lease commitments at June 30, 2018.

Table 13.1 – Future Lease Commitments by Year

(In Thousands)	June 30, 2018
2018 (6 months)	\$982
2019	1,987
2020	1,965
2021	1,474
2022 and thereafter	10,217
Total Lease Commitments	\$16,625

Commitments to Fund Equity Investments

At June 30, 2018, we had committed to fund \$50 million to a limited partnership created to finance clean energy projects. This obligation may be requested at any time by the investment manager and will be recorded on our balance sheet as an equity method investment upon funding. At June 30, 2018, no investments in this partnership had been funded.

Commitment to Participate in Loan Warehouse Facility

In the second quarter of 2018, we invested in a participation in the mortgage loan warehouse credit facility of one of our loan sellers. This investment includes a commitment to participate in (and an obligation to fund) a designated amount of the loan seller's borrowings under this warehouse credit facility. This obligation is subject to daily funding requests by the financial institution, and fundings are recorded on our balance sheet as a Participation in loan warehouse facility. At June 30, 2018, \$42 million of our commitment had been funded, and we were committed to fund up to an additional \$8 million. See Note 9 for additional detail on our participation in a loan warehouse facility.

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Note 13. Commitments and Contingencies - (continued)

Loss Contingencies — Risk-Sharing

During 2015 and 2016, we sold conforming loans to the Agencies with an original unpaid principal balance of \$3.19 billion, subject to our risk-sharing arrangements with the Agencies. At June 30, 2018, the maximum potential amount of future payments we could be required to make under these arrangements was \$44 million and this amount was fully collateralized by assets we transferred to pledged accounts and is presented as pledged collateral in Other assets on our consolidated balance sheets. We have no recourse to any third parties that would allow us to recover any amounts related to our obligations under the arrangements. At June 30, 2018, we had not incurred any losses under these arrangements. For the three and six months ended June 30, 2018, other income related to these arrangements was \$1 million and \$2 million, respectively, and net market valuation losses related to these investments were \$0.2 million and \$0.3 million, respectively. For the three and six months ended June 30, 2017, other income related to these arrangements was \$1 million and \$2 million, respectively, and net market valuation losses related to these investments were \$1 million for both periods.

All of the loans in the reference pools subject to these risk-sharing arrangements were originated in 2014 and 2015, and at June 30, 2018, the loans had an unpaid principal balance of \$1.95 billion and a weighted average FICO score of 758 (at origination) and LTV of 76% (at origination). At June 30, 2018, \$5 million of the loans were 90 days or more delinquent, of which \$1 million were in foreclosure. At June 30, 2018, the carrying value of our guarantee obligation was \$18 million and included \$6 million designated as a non-amortizing credit reserve, which we believe is sufficient to cover current expected losses under these obligations.

Our consolidated balance sheets include assets of special purpose entities ("SPEs") associated with these risk-sharing arrangements (i.e., the "pledged collateral" referred to above) that can only be used to settle obligations of these SPEs for which the creditors of these SPEs (the Agencies) do not have recourse to Redwood Trust, Inc. or its affiliates. At June 30, 2018 and December 31, 2017, assets of such SPEs totaled \$47 million and \$48 million, respectively, and liabilities of such SPEs totaled \$18 million and \$19 million, respectively.

Loss Contingencies — Residential Repurchase Reserve

We maintain a repurchase reserve for potential obligations arising from representation and warranty violations related to residential loans we have sold to securitization trusts or third parties and for conforming residential loans associated with MSRMs that we have purchased from third parties. We do not originate residential loans and we believe the initial risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans. However, in some cases, for example, where loans were acquired from companies that have since become insolvent, repurchase claims may result in our being liable for a repurchase obligation.

At June 30, 2018 and December 31, 2017, our repurchase reserve associated with our residential loans and MSRMs was \$4 million and \$5 million, respectively, and was recorded in Accrued expenses and other liabilities on our consolidated balance sheets. We received two repurchase requests during the six months ended June 30, 2018, and did not repurchase any loans during this period. During the six months ended June 30, 2018 and 2017, we recorded reversals of repurchase provision of \$0.5 million and \$0.9 million, respectively, that were recorded in Mortgage banking activities, net and Other income, net on our consolidated statements of income.

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Note 13. Commitments and Contingencies - (continued)

Loss Contingencies — Litigation

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the “FHLB-Seattle”) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (“SRF”), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the “FHLB-Seattle Defendants”), which alleged that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Seattle Certificate”) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the “2005-4 RMBS”) and purchased by the FHLB-Seattle. Specifically, the complaint alleged that the alleged misstatements concerned the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleged claims under the Securities Act of Washington (Section 21.20.005, et seq.) and sought to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys’ fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, at June 30, 2018, approximately \$126 million of principal and \$11 million of interest payments had been made in respect of the Seattle Certificate. The matter was subsequently resolved and the claims were dismissed by the FHLB Seattle as to all the FHLB Seattle Defendants. At the time the Seattle Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were named as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the resolution of this litigation, we could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (“Schwab”) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the “Schwab Defendants”), which alleged that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. Schwab alleged only a claim for negligent misrepresentation under California state law against SRF and sought unspecified damages and attorneys’ fees and costs from SRF. Schwab claimed that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Schwab Certificate”) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleged that the misstatements for the 2005-4 RMBS concerned the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. The Schwab Certificate was issued with an original principal amount of approximately \$15 million, and, at June 30, 2018, approximately \$14 million of principal and \$1 million of interest payments had been made in respect of the Schwab Certificate. On November 14, 2014, Schwab voluntarily dismissed with prejudice its negligent misrepresentation claim, which resulted in the dismissal with prejudice of SRF from the action. Subsequently, the matter was resolved and Schwab dismissed its claims against the lead underwriter of the 2005-4 RMBS. At the time the Schwab Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the resolution of this litigation, Redwood could incur a loss as a result of these indemnities.

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(Unaudited)

Note 13. Commitments and Contingencies - (continued)

Through certain of our wholly-owned subsidiaries, we have in the past engaged in, and expect to continue to engage in, activities relating to the acquisition and securitization of residential mortgage loans. In addition, certain of our wholly-owned subsidiaries have in the past engaged in activities relating to the acquisition and securitization of debt obligations and other assets through the issuance of collateralized debt obligations (commonly referred to as CDO transactions). Because of this involvement in the securitization and CDO businesses, we could become the subject of litigation relating to these businesses, including additional litigation of the type described above, and we could also become the subject of governmental investigations, enforcement actions, or lawsuits, and governmental authorities could allege that we violated applicable law or regulation in the conduct of our business. As an example, in July 2016 we became aware of a complaint filed by the State of California on April 1, 2016 against Morgan Stanley & Co. and certain of its affiliates alleging, among other things, that there were misleading statements contained in offering materials for 28 different mortgage pass-through certificates purchased by various California investors, including various California public pension systems, from Morgan Stanley and alleging that Morgan Stanley made false or fraudulent claims in connection with the sale of those certificates. Of the 28 mortgage pass-through certificates that were the subject of the complaint, two were Sequoia mortgage pass-through certificates issued in 2004 and two were Sequoia mortgage pass-through certificates issued in 2007. With respect to each of those certificates, our wholly-owned subsidiary, RWT Holdings, Inc., was the sponsor and our wholly-owned subsidiary, Sequoia Residential Funding, Inc., was the depositor. The plaintiffs subsequently withdrew from the litigation their claims based on eight of the 28 mortgage pass-through certificates, including one of the Sequoia mortgage pass-through certificates issued in 2004. At the time these Sequoia mortgage pass-through certificates were issued, Sequoia Residential Funding, Inc. and Redwood Trust agreed to indemnify the underwriters of these certificates for certain losses and expenses they might incur as a result of claims made against them relating to these certificates, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At June 30, 2018, the aggregate amount of loss contingency reserves established in respect of the FHLB-Seattle and Schwab litigation matters described above was \$2 million. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

In the ordinary course of any litigation matter, including certain of the above-referenced matters, we have engaged and may continue to engage in formal or informal settlement communications with the plaintiffs or co-defendants.

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

Future developments (including resolution of substantive pre-trial motions relating to these matters, receipt of additional information and documents relating to these matters (such as through pre-trial discovery), new or additional settlement communications with plaintiffs relating to these matters, or resolutions of similar claims against other defendants in these matters) could result in our concluding in the future to establish additional loss contingency reserves or to disclose an estimate of reasonably possible losses in excess of our established reserves with respect to

these matters. Our actual losses with respect to the above-referenced litigation matters may be materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters, including in the event that any of these matters proceeds to trial and the plaintiff prevails. Other factors that could result in our concluding to establish additional loss contingency reserves or estimate additional reasonably possible losses, or could result in our actual losses with respect to the above-referenced litigation matters being materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters include that: there are significant factual and legal issues to be resolved; information obtained or rulings made during the lawsuits could affect the methodology for calculation of the available remedies; and we may have additional obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters that could increase our potential losses.

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Note 14. Equity

The following table provides a summary of changes to accumulated other comprehensive income by component for the three and six months ended June 30, 2018 and 2017.

Table 14.1 – Changes in Accumulated Other Comprehensive Income by Component

	Three Months Ended June 30, 2018		Three Months Ended June 30, 2017	
	Net Unrealized Net Unrealized Gains on Available-for-Sale Securities	Interest Rate Agreements for as Cash Flow Hedges	Net Unrealized Net Unrealized Gains on Available-for-Sale Securities	Interest Rate Agreements for as Cash Flow Hedges
(In Thousands)				
Balance at beginning of period	\$114,577	\$ (34,522)	\$114,875	\$ (42,273)
Other comprehensive (loss) income before reclassifications ⁽¹⁾	(3,104)	3,417	1,811	(2,429)
Amounts reclassified from other accumulated comprehensive income	(4,748)	—	(2,322)	14
Net current-period other comprehensive (loss) income	(7,852)	3,417	(511)	(2,415)
Balance at End of Period	\$106,725	\$ (31,105)	\$114,364	\$ (44,688)
	Six Months Ended June 30, 2018		Six Months Ended June 30, 2017	
	Net Unrealized Net Unrealized Gains on Available-for-Sale Securities	Interest Rate Agreements for as Cash Flow Hedges	Net Unrealized Net Unrealized Gains on Available-for-Sale Securities	Interest Rate Agreements for as Cash Flow Hedges
(In Thousands)				
Balance at beginning of period	\$128,201	\$ (42,953)	\$115,873	\$ (44,020)
Other comprehensive income (loss) before reclassifications ⁽¹⁾	(7,341)	11,848	4,741	(696)
Amounts reclassified from other accumulated comprehensive income	(14,135)	—	(6,250)	28
Net current-period other comprehensive income (loss)	(21,476)	11,848	(1,509)	(668)
Balance at End of Period	\$106,725	\$ (31,105)	\$114,364	\$ (44,688)

Amounts presented for net unrealized gains on available-for-sale securities are net of tax benefit (provision) of \$0.2 (1) million and \$0.1 million for the three and six months ended June 30, 2018, respectively, and \$0.1 million and \$(0.1) million for the three and six months ended June 30, 2017, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 14. Equity - (continued)

The following table provides a summary of reclassifications out of accumulated other comprehensive income for the three and six months ended June 30, 2018 and 2017.

Table 14.2 – Reclassifications Out of Accumulated Other Comprehensive Income

(In Thousands)	Affected Line Item in the Income Statement	Amount Reclassified From Accumulated Other Comprehensive Income Three Months Ended June 30, 2018 2017	
Net Realized (Gain) Loss on AFS Securities Other than temporary impairment ⁽¹⁾	Investment fair value changes, net	\$56	\$128
Gain on sale of AFS securities	Realized gains, net	(4,804)	(2,450)
		\$(4,748)	\$(2,322)
Net Realized Loss on Interest Rate Agreements Designated as Cash Flow Hedges			
Amortization of deferred loss	Interest expense	\$—	\$14
		\$—	\$14
(In Thousands)	Affected Line Item in the Income Statement	Amount Reclassified From Accumulated Other Comprehensive Income Six Months Ended June 30, 2018 2017	
Net Realized (Gain) Loss on AFS Securities Other than temporary impairment ⁽¹⁾	Investment fair value changes, net	\$56	\$245
Gain on sale of AFS securities	Realized gains, net	(14,191)	(6,495)
		\$(14,135)	\$(6,250)
Net Realized Loss on Interest Rate Agreements Designated as Cash Flow Hedges			
Amortization of deferred loss	Interest expense	\$—	\$28
		\$—	\$28

(1) For the three and six months ended June 30, 2018, other-than-temporary impairments were \$0.3 million, of which \$0.1 million were recognized through our consolidated statements of income and \$0.2 million were recognized in Accumulated other comprehensive income, a component of our consolidated balance sheet. For the three months ended June 30, 2017, other-than-temporary impairments were \$0.5 million, of which \$0.1 million were recognized through our consolidated statements of income and \$0.3 million were recognized in Accumulated other comprehensive income, a component of our consolidated balance sheet. For the six months ended June 30, 2017,

other-than-temporary impairments were \$0.6 million, of which \$0.2 million were recognized through our consolidated statements of income and \$0.4 million were recognized in Accumulated other comprehensive income, a component of our consolidated balance sheet.

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Note 14. Equity - (continued)

Earnings per Common Share

The following table provides the basic and diluted earnings per common share computations for the three and six months ended June 30, 2018 and 2017.

Table 14.3 – Basic and Diluted Earnings per Common Share

(In Thousands, except Share Data)	Three Months Ended		Six Months Ended	
	June 30, 2018	2017	June 30, 2018	2017
Basic Earnings per Common Share:				
Net income attributable to Redwood	\$32,747	\$36,324	\$79,592	\$73,293
Less: Dividends and undistributed earnings allocated to participating securities	(1,074)	(884)	(2,535)	(1,852)
Net income allocated to common shareholders	\$31,673	\$35,440	\$77,057	\$71,441
Basic weighted average common shares outstanding	75,380,715	76,819,703	75,388,638	76,779,178
Basic Earnings per Common Share	\$0.42	\$0.46	\$1.02	\$0.93
Diluted Earnings per Common Share:				
Net income attributable to Redwood	\$32,747	\$36,324	\$79,592	\$73,293
Less: Dividends and undistributed earnings allocated to participating securities	(1,156)	(935)	(2,584)	(1,940)
Add back: Interest expense on convertible notes for the period, net of tax	6,335	6,205	14,976	12,075
Net income allocated to common shareholders	\$37,926	\$41,594	\$91,984	\$83,428
Weighted average common shares outstanding	75,380,715	76,819,703	75,388,638	76,779,178
Net effect of dilutive equity awards	277,788	235,273	156,307	173,235
Net effect of assumed convertible notes conversion to common shares	24,773,490	20,439,168	28,746,235	20,766,137
Diluted weighted average common shares outstanding	100,431,993	97,494,144	104,291,180	97,718,550
Diluted Earnings per Common Share	\$0.38	\$0.43	\$0.88	\$0.85

We included participating securities, which are certain equity awards that have non-forfeitable dividend participation rights, in the calculations of basic and diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method for these shares. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances.

During the three and six months ended June 30, 2018 and 2017, certain of our convertible notes were determined to be dilutive and were included in the calculation of diluted EPS under the "if-converted" method. Under this method, the periodic interest expense (net of applicable taxes) for dilutive notes is added back to the numerator and the weighted average number of shares that the notes are entitled to (if converted, regardless of whether they are in or out of the money) are included in the denominator.

For the three and six months ended June 30, 2018, the number of outstanding equity awards that were antidilutive totaled 7,091 and 6,965, respectively. For the three and six months ended June 30, 2017, the number of outstanding equity awards that were antidilutive totaled 5,555 and 5,691, respectively.

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Note 14. Equity - (continued)

Stock Repurchases

In February 2016, our Board of Directors approved an authorization for the repurchase of up to \$100 million of our common stock and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. This authorization replaced all previous share repurchase plans and has no expiration date. During the year ended December 31, 2017, we repurchased 610,342 shares of common stock pursuant to this authorization for \$9 million. At December 31, 2017, approximately \$77 million of this current authorization remained available for the repurchase of shares of our common stock. During January 2018, we repurchased 1,040,829 shares of our common stock pursuant to this authorization for \$16 million.

In February 2018, our Board of Directors approved an authorization for the repurchase of an additional \$39 million of our common stock, increasing the total amount authorized for repurchases of common stock to \$100 million, and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. As noted above, this authorization increased the previous share repurchase authorization approved in February 2016 and has no expiration date. This repurchase authorization does not obligate us to acquire any specific number of shares or securities. Under this authorization, shares or securities may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. At June 30, 2018, \$100 million of the current authorization remained available for the repurchase of shares of our common stock.

Note 15. Equity Compensation Plans

At June 30, 2018 and December 31, 2017, 4,882,986 and 1,356,438 shares of common stock, respectively, were available for grant under our Incentive Plan. During the three months ended June 30, 2018, Redwood shareholders approved for grant an additional 4,000,000 shares of common stock under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled \$23 million at June 30, 2018, as shown in the following table.

Table 15.1 – Activities of Equity Compensation Costs by Award Type

(In Thousands)	Six Months Ended June 30, 2018				
	Restricted Stock	Deferred Stock Units	Performance Stock Units	Employee Stock Purchase Plan	Total
Unrecognized compensation cost at beginning of period	\$2,808	\$13,364	\$ 5,298	\$ —	\$21,470
Equity grants	2,380	4,750	350	136	7,616
Equity grant forfeitures	—	—	—	—	—
Equity compensation expense	(806)	(4,371)	(1,287)	(68)	(6,532)
Unrecognized Compensation Cost at End of Period	\$4,382	\$13,743	\$ 4,361	\$ 68	\$22,554

At June 30, 2018, the weighted average amortization period remaining for all of our equity awards was less than two years.

Restricted Stock

At June 30, 2018 and December 31, 2017, there were 337,253 and 257,507 shares, respectively, of restricted stock outstanding. Restrictions on these shares lapse through 2022. During the six months ended June 30, 2018, there were 162,330 shares of restricted stock granted, restrictions on 82,584 shares of restricted stock lapsed and those shares were distributed, and no shares of restricted stock awards were forfeited.

Deferred Stock Units (“DSUs”)

At June 30, 2018 and December 31, 2017, there were 2,233,954 and 1,878,491 DSUs, respectively, outstanding of which 1,189,795 and 889,835, respectively, had vested. During the six months ended June 30, 2018, there were 387,984 DSUs granted, 32,521 DSUs distributed, and no DSUs forfeited. Unvested DSUs at June 30, 2018 vest through 2022.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 15. Equity Compensation Plans - (continued)

Performance Stock Units ("PSUs")

At June 30, 2018 and December 31, 2017, the target number of PSUs that were unvested was 727,295 and 704,270, respectively. Vesting for these PSUs will generally occur at the end of three years from their grant date, with the level of vesting at that time contingent on total shareholder return ("TSR"). TSR for these PSUs is defined as the percentage by which our common stock "per share price" has increased or decreased as of the last day of the three-year vesting period relative to the first day of such vesting period, adjusted to reflect the reinvestment of all dividends declared and/or paid on our common stock ("Three-Year TSR"). The number of underlying shares of our common stock that will vest in future years will vary between 0% (if Three-Year TSR is zero or negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the target number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period.

During the three months ended June 30, 2018, 23,025 target number of PSUs with a per unit grant date fair value of \$15.20 were granted to two executives in connection with their promotions. The grant date fair values of these PSUs were determined through Monte-Carlo simulations using the following assumptions: our common stock closing price at the grant date, the average closing price of our common stock price for the 60 trading days prior to the grant date and the range of performance-based vesting based on TSR over three years from the grant date. For this PSU grant, an implied volatility assumption of 27% (based on historical volatility), a risk-free rate of 2.71% (the three-year Treasury rate on the grant date), and a 0% dividend yield (the mathematical equivalent to reinvesting the dividends over the three-year performance period as is consistent with the terms of the PSUs) were used.

Vesting for all PSUs will generally occur at the end of three years from their grant date based on various TSR performance calculations, as discussed in our Annual Report on Form 10-K for the year ended December 31, 2017.

Employee Stock Purchase Plan ("ESPP")

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. As of June 30, 2018 and December 31, 2017, 374,935 and 361,006 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP at June 30, 2018.

Note 16. Mortgage Banking Activities, Net

The following table presents the components of Mortgage banking activities, net, recorded in our consolidated statements of income for the three and six months ended June 30, 2018 and 2017.

Table 16.1 – Mortgage Banking Activities

(In Thousands)	Three Months		Six Months Ended	
	Ended June 30, 2018	2017	June 30, 2018	2017
Mortgage Banking Activities, Net				
Changes in fair value of:				
Residential loans, at fair value ⁽¹⁾	\$3,364	\$16,190	\$1,170	\$34,986
Risk management derivatives ⁽²⁾	6,150	(5,310)	34,582	(6,710)
Other income, net ⁽³⁾	1,082	1,166	1,420	1,374
Mortgage Banking Activities, Net	\$10,596	\$12,046	\$37,172	\$29,650

(1) Includes changes in fair value for associated loan purchase and forward sale commitments.

(2) Represents market valuation changes of derivatives that were used to manage risks associated with our accumulation of residential loans.

(3) Amounts in this line item include other fee income from loan acquisitions and the provision for repurchases expense, presented net.

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Note 17. Investment Fair Value Changes, Net

The following table presents the components of Investment fair value changes, net, recorded in our consolidated statements of income for the three and six months ended June 30, 2018 and 2017.

Table 17.1 – Investment Fair Value Changes

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Investment Fair Value Changes, Net				
Changes in fair value of:				
Residential loans held-for-investment, at Redwood	\$(15,010)	\$8,354	\$(53,995)	\$6,021
Trading securities	(930)	18,926	(3,885)	30,069
Net investments in Legacy Sequoia entities ⁽¹⁾	(720)	(987)	(728)	(2,797)
Net investments in Sequoia Choice entities ⁽¹⁾	1,072	—	986	—
Risk-sharing investments	(209)	(513)	(348)	(718)
Risk management derivatives, net	16,742	(17,838)	60,524	(22,965)
Valuation adjustments on commercial loans held-for-sale	—	300	—	300
Impairments on AFS securities	(56)	(127)	(56)	(244)
Investment Fair Value Changes, Net	\$889	\$8,115	\$2,498	\$9,666

⁽¹⁾ Includes changes in fair value of the residential loans held-for-investment, REO and the ABS issued at the entities, which netted together represent the change in value of our retained investments at the consolidated VIEs.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 18. Operating Expenses

Components of our operating expenses for the three and six months ended June 30, 2018 and 2017 are presented in the following table.

Table 18.1 – Components of Operating Expenses

(In Thousands)	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2018	2017	2018	2017
Fixed compensation expense	\$5,775	\$5,321	\$12,214	\$11,323
Variable compensation expense	1,825	4,313	8,732	8,246
Equity compensation expense	3,835	3,121	6,532	5,297
Total compensation expense	11,435	12,755	27,478	24,866
Systems and consulting	1,774	1,689	3,640	3,327
Loan acquisition costs ⁽¹⁾	2,155	1,005	3,973	2,210
Office costs	1,084	1,140	2,224	2,243
Accounting and legal	1,074	877	1,908	1,803
Corporate costs	496	508	1,000	948
Other operating expenses	991	667	1,816	1,470
Total Operating Expenses	\$19,009	\$18,641	\$42,039	\$36,867

(1) Loan acquisition costs primarily includes underwriting and due diligence costs related to the acquisition of residential loans held-for-sale at fair value.

Note 19. Taxes

For the six months ended June 30, 2018 and 2017, we recognized a provision for income taxes of \$7 million and \$11 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our effective tax rate at June 30, 2018 and 2017.

Table 19.1 – Reconciliation of Statutory Tax Rate to Effective Tax Rate

	June 30, 2018		June 30, 2017	
Federal statutory rate	21.0	%	34.0	%
State statutory rate, net of Federal tax effect	8.6	%	7.2	%
Differences in taxable (loss) income from GAAP income	(2.9)	%	(7.2)	%
Change in valuation allowance	(3.3)	%	(2.9)	%
Dividends paid deduction	(14.9)	%	(17.6)	%
Effective Tax Rate	8.5	%	13.5	%

The reduction of the federal statutory rate from 34% to 21% is due to the enactment of the Tax Act.

We assessed our tax positions for all open tax years (i.e., Federal, 2014 to 2018, and State, 2013 to 2018) at June 30, 2018 and December 31, 2017, and concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 20. Segment Information

Redwood operates in two segments: Investment Portfolio and Residential Mortgage Banking. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For a full description of our segments, see Item 1—Business in our Annual Report on Form 10-K for the year ended December 31, 2017.

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

The following tables present financial information by segment for the three and six months ended June 30, 2018 and 2017.

Table 20.1 – Business Segment Financial Information

(In Thousands)	Three Months Ended June 30, 2018			Total
	Investment Portfolio	Residential Mortgage Banking	Corporate/Other	
Interest income	\$64,569	\$ 13,084	\$ 5,323	\$82,976
Interest expense	(27,004)	(7,629)	(13,580)	(48,213)
Net interest income (loss)	37,565	5,455	(8,257)	34,763
Non-interest income				
Mortgage banking activities, net	—	10,596	—	10,596
Investment fair value changes, net	1,600	—	(711)	889
Other income, net	3,322	—	—	3,322
Realized gains, net	4,714	—	—	4,714
Total non-interest income, net	9,636	10,596	(711)	19,521
Direct operating expenses	(1,858)	(5,611)	(11,540)	(19,009)
Provision for income taxes	(1,130)	(1,398)	—	(2,528)
Segment Contribution	\$44,213	\$ 9,042	\$ (20,508)	
Net Income				\$32,747
Non-cash amortization income (expense), net	\$4,654	\$ (23)	\$ (814)	\$3,817

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Note 20. Segment Information - (continued)

	Three Months Ended June 30, 2017			
(In Thousands)	Investment Portfolio	Residential Mortgage Banking	Corporate/ Other	Total
Interest income	\$45,833	\$ 8,415	\$ 4,976	\$59,224
Interest expense	(7,231)	(4,403)	(12,600)	(24,234)
Net interest income (loss)	38,602	4,012	(7,624)	34,990
Non-interest income				
Mortgage banking activities, net	—	12,046	—	12,046
Investment fair value changes, net	9,115	—	(1,000)	8,115
Other income, net	3,764	—	—	3,764
Realized gains, net	2,124	—	(752)	1,372
Total non-interest income, net	15,003	12,046	(1,752)	25,297
Direct operating expenses	(1,454)	(6,021)	(11,166)	(18,641)
Provision for income taxes	(2,320)	(3,002)	—	(5,322)
Segment Contribution	\$49,831	\$ 7,035	\$(20,542)	
Net Income				\$36,324
Non-cash amortization income (expense)	\$5,194	\$ (27)	\$(744)	\$4,423
	Six Months Ended June 30, 2018			
(In Thousands)	Investment Portfolio	Residential Mortgage Banking	Corporate/ Other	Total
Interest income	\$123,326	\$ 25,981	\$ 10,288	\$159,595
Interest expense	(46,867)	(13,766)	(29,094)	(89,727)
Net interest income (loss)	76,459	12,215	(18,806)	69,868
Non-interest income				
Mortgage banking activities, net	—	37,172	—	37,172
Investment fair value changes, net	3,190	—	(692)	2,498
Other income, net	5,440	—	—	5,440
Realized gains, net	14,077	—	—	14,077
Total non-interest income, net	22,707	37,172	(692)	59,187
Direct operating expenses	(3,865)	(14,243)	(23,931)	(42,039)
Provision for income taxes	(2,018)	(5,406)	—	(7,424)
Segment Contribution	\$93,283	\$ 29,738	\$(43,429)	
Net Income				\$79,592
Non-cash amortization income (expense)	\$9,271	\$ (45)	\$(1,672)	\$7,554

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Note 20. Segment Information - (continued)

(In Thousands)	Six Months Ended June 30, 2017			
	Investment Portfolio	Residential Mortgage Banking	Corporate/ Other	Total
Interest income	\$88,083	\$ 15,889	\$ 9,880	\$ 113,852
Interest expense	(12,495)	(7,327)	(25,443)	(45,265)
Net interest income (loss)	75,588	8,562	(15,563)	68,587
Non-interest income				
Mortgage banking activities, net	—	29,650	—	29,650
Investment fair value changes, net	12,474	—	(2,808)	9,666
Other income, net	6,661	—	—	6,661
Realized gains, net	7,827	—	(752)	7,075
Total non-interest income, net	26,962	29,650	(3,560)	53,052
Direct operating expenses	(3,047)	(11,902)	(21,918)	(36,867)
Provision for income taxes	(4,057)	(7,422)	—	(11,479)
Segment Contribution	\$95,446	\$ 18,888	\$(41,041)	
Net Income				\$73,293
Non-cash amortization income (expense)	\$ 11,041	\$(54)	\$(1,741)	\$9,246

The following table presents the components of Corporate/Other for the three and six months ended June 30, 2018 and 2017.

Table 20.2 – Components of Corporate/Other

(In Thousands)	Three Months Ended June 30,					
	2018			2017		
	Legacy Consolidated VIEs ⁽¹⁾	Other	Total	Legacy Consolidated VIEs ⁽¹⁾	Other	Total
Interest income	\$5,017	\$306	\$5,323	\$4,863	\$113	\$4,976
Interest expense	(4,215)	(9,365)	(13,580)	(3,692)	(8,908)	(12,600)
Net interest income (loss)	802	(9,059)	(8,257)	1,171	(8,795)	(7,624)
Non-interest income						
Investment fair value changes, net	(720)	9	(711)	(987)	(13)	(1,000)
Realized gains, net	—	—	—	—	(752)	(752)
Total non-interest income, net	(720)	9	(711)	(987)	(765)	(1,752)
Direct operating expenses	—	(11,540)	(11,540)	—	(11,166)	(11,166)
Total	\$82	\$(20,590)	\$(20,508)	\$184	\$(20,726)	\$(20,542)

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018

(Unaudited)

Note 20. Segment Information - (continued)

(In Thousands)	Six Months Ended June 30,					
	2018			2017		
	Legacy		Total	Legacy		Total
Consolidated	Other	Consolidated		Other		
	VIEs ⁽¹⁾			VIEs ⁽¹⁾		
Interest income	\$9,829	\$459	\$10,288	\$9,701	\$179	\$9,880
Interest expense	(8,067)	(21,027)	(29,094)	(7,208)	(18,235)	(25,443)
Net interest income (loss)	1,762	(20,568)	(18,806)	2,493	(18,056)	(15,563)
Non-interest income						
Investment fair value changes, net	(728)	36	(692)	(2,797)	(11)	(2,808)
Realized gains, net	—	—	—	—	(752)	(752)
Total non-interest income, net	(728)	36	(692)	(2,797)	(763)	(3,560)
Direct operating expenses	—	(23,931)	(23,931)	—	(21,918)	(21,918)
Total	\$1,034	\$(44,463)	\$(43,429)	\$(304)	\$(40,737)	\$(41,041)

(1) Legacy consolidated VIEs represent Legacy Sequoia entities that are consolidated for GAAP financial reporting purposes. See Note 4 for further discussion on VIEs.

The following table presents supplemental information by segment at June 30, 2018 and December 31, 2017.

Table 20.3 – Supplemental Segment Information

(In Thousands)	Investment Portfolio	Residential Mortgage Banking	Corporate/ Other	Total
June 30, 2018				
Residential loans	\$3,794,481	\$1,104,660	\$592,029	\$5,491,170
Real estate securities	1,453,936	—	—	1,453,936
Total assets	5,591,778	1,124,300	796,473	7,512,551
December 31, 2017				
Residential loans	\$3,054,448	\$1,427,945	\$632,817	\$5,115,210
Real estate securities	1,476,510	—	—	1,476,510
Total assets	4,743,873	1,453,069	842,880	7,039,822

Note 21. Subsequent Events

On July 24, 2018, we sold 7,187,500 shares of common stock in an underwritten public offering, resulting in net proceeds of approximately \$117 million.

On August 7, 2018, we purchased approximately \$100 million of mortgage loans to investors rehabilitating residential homes from an affiliate of 5 Arches LLC, a business-purpose lender and asset manager. As part of this transaction, from time to time, we will purchase 5 Arches' future originations of such loans. We currently own a 20% minority investment in 5 Arches, as described in Note 9.

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

INTRODUCTION

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

• Overview

• Results of Operations

• Liquidity and Capital Resources

• Off-Balance Sheet Arrangements and Contractual Obligations

• Critical Accounting Policies and Estimates

• New Accounting Standards

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

References herein to "Redwood," the "company," "we," "us," and "our" include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in this "Management's Discussion and Analysis of Financial Condition and Results of Operations," and our consolidated financial statements and notes thereto, which are included in Part I, Item 1 of this Quarterly Report on Form 10-Q. Our website can be found at www.redwoodtrust.com. We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission ("SEC"). We also make available, free of charge, access to our charters for our Audit Committee, Compensation Committee, and Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer or director of Redwood. In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, and may include disclosure relating to certain non-GAAP financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. The information on our website is not part of this Quarterly Report on Form 10-Q.

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

Our Business

Redwood Trust, Inc., together with its subsidiaries, is a specialty finance company focused on making credit-sensitive investments in residential mortgages and related assets and engaging in mortgage banking activities. Our goal is to provide attractive returns to shareholders through a stable and growing stream of earnings and dividends, as well as through capital appreciation. We operate our business in two segments: Investment Portfolio and Residential Mortgage Banking. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For a full description of our segments, see Item 1—Business in our Annual Report on Form 10-K for the year ended December 31, 2017.

Our primary sources of income are net interest income from our investment portfolio and non-interest income from our mortgage banking activities. Net interest income consists of the interest income we earn on investments less the interest expense we incur on borrowed funds and other liabilities. Income from mortgage banking activities is generated through the acquisition of loans and their subsequent sale or securitization.

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), beginning with its taxable year ended December 31, 1994. We generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as “the REIT” or “our REIT.” We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as “our operating subsidiaries” or “our taxable REIT subsidiaries” or “TRS.” Our mortgage banking activities and investments in MSRs are generally carried out through our taxable REIT subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our taxable REIT subsidiaries, and to distribute as dividends at least 90% of the taxable income we generate at our REIT.

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

Cautionary Statement

This Quarterly Report on Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as “anticipate,” “estimate,” “will,” “should,” “expect,” “believe,” “intend,” “seek,” “plan” and similar expressions or their forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 and this Quarterly Report on Form 10-Q, in each case under the caption “Risk Factors.” Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) statements we make regarding Redwood’s business strategy and strategic focus, including statements relating to our overall market position, strategy and long-term prospects (including our strategic focus on areas in which our core business strengths are expected to lead to long-term, sustainable earnings growth); (ii) statements related to expanding our mortgage banking activities and investment portfolio to include mortgage loans secured by single-family rental properties; (iii) statements regarding our mortgage banking activities, including expectations relating to residential mortgage banking margins, loan purchase volume, and our expanded-prime Redwood Choice loan program; (iv) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase or plan to purchase, including the amount of such loans that we identified for purchase during the second quarter of 2018 and at June 30, 2018, and expected fallout and the corresponding volume of residential mortgage loans expected to be available for purchase; (v) statements relating to our estimate of our available capital (including that we estimate our available capital at June 30, 2018 was approximately \$200 million), and expectations relating to sourcing additional capital from continued optimization of our investment portfolio and from capital markets; (vi) statements we make regarding our dividend

policy, including with respect to our regular quarterly dividends in 2018; and (vii) statements regarding our expectations and estimates relating to the characterization for income tax purposes of our dividend distributions, our expectations and estimates relating to tax accounting, tax liabilities and tax savings, and GAAP tax provisions, and our estimates of REIT taxable income and TRS taxable income.

Important factors, among others, that may affect our actual results include:

- the pace at which we redeploy our available capital into new investments and initiatives;
- our ability to scale our platform and systems, particularly with respect to our new initiatives;
- interest rate volatility, changes in credit spreads, and changes in liquidity in the market for real estate securities and loans;
- changes in the demand from investors for residential mortgages and investments, and our ability to distribute residential mortgages through our whole-loan distribution channel;
- our ability to finance our investments in securities and our acquisition of residential mortgages with short-term debt;
- changes in the values of assets we own;
- general economic trends, the performance of the housing, real estate, mortgage, credit, and broader financial markets, and their effects on the prices of earning assets and the credit status of borrowers;
- federal and state legislative and regulatory developments, and the actions of governmental authorities, including the new U.S. presidential administration, and in particular those affecting the mortgage industry or our business (including, but not limited to, the Federal Housing Finance Agency's rules relating to FHLB membership requirements and the implications for our captive insurance subsidiary's membership in the FHLB);
- strategic business and capital deployment decisions we make;
- developments related to the fixed income and mortgage finance markets and the Federal Reserve's statements regarding its future open market activity and monetary policy;
- our exposure to credit risk and the timing of credit losses within our portfolio;
- the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own;
- our exposure to adjustable-rate mortgage loans;
- the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks;
- changes in credit ratings on assets we own and changes in the rating agencies' credit rating methodologies;
- changes in interest rates; changes in mortgage prepayment rates;
- changes in liquidity in the market for real estate securities and loans;
- our ability to finance the acquisition of real estate-related assets with short-term debt;
- the ability of counterparties to satisfy their obligations to us;
- our involvement in securitization transactions, the profitability of those transactions, and the risks we are exposed to in engaging in securitization transactions;
- exposure to claims and litigation, including litigation arising from our involvement in securitization transactions;
- ongoing litigation against various trustees of RMBS transactions;
- whether we have sufficient liquid assets to meet short-term needs;
- our ability to successfully compete and retain or attract key personnel;
- our ability to adapt our business model and strategies to changing circumstances;
- changes in our investment, financing, and hedging strategies and new risks we may be exposed to if we expand our business activities;
- our exposure to a disruption or breach of the security of our technology infrastructure and systems;
- exposure to environmental liabilities;
- our failure to comply with applicable laws and regulations;
- our failure to maintain appropriate internal controls over financial reporting and disclosure controls and procedures;
- the impact on our reputation that could result from our actions or omissions or from those of others; changes in accounting principles and tax rules;
- our ability to maintain our status as a REIT for tax purposes;
- limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940;
- decisions about raising, managing, and distributing capital; and
- other factors not presently identified.

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

OVERVIEW

Business Update

Our business strategy is focused on areas in which our core competencies and competitive strengths are expected to lead to long-term, sustainable earnings growth for Redwood. Specifically, we plan to focus our business on areas that achieve the following:

- Our capital deployment is value-added to the marketplace
- There is a long runway of durable revenues available to us
- Our core strengths are a competitive advantage
- We can scale profitably and realize significant operating efficiencies
- We feel the risks associated with investing can be prudently managed

Our recent and new initiatives are focused on advancing our business strategy. For example, Redwood Choice - our expanded-prime loan channel - now represents almost one-third of our mortgage banking volumes. Our total loan origination volume, meanwhile, remains on track to increase meaningfully from last year amidst declining industry originations. Our investment portfolio continues to deepen its purchasing power by diversifying into other housing investments, such as Freddie Mac-sponsored multifamily bonds. Most recently, our investment in mortgage originator and asset manager 5 Arches gives us access to an attractive pipeline of single-family rental and other “business-purpose” mortgage loans and a growing stream of asset management revenues.

Second Quarter Overview

We carried forward our momentum from earlier this year into the second quarter, making meaningful operational progress and producing solid financial performance. During the second quarter, we increased loan purchase volumes in our mortgage banking business, increased capital deployment in our investment portfolio, and completed our first "M&A" style transaction in several years, advancing on our strategic initiatives. Additionally, in June, we issued \$200 million of convertible debt and, in July, after it was announced that we were being added to the S&P SmallCap 600 index, we successfully issued \$117 million of common equity in our first follow-on stock offering since 2009.

Our second quarter earnings represented a more normalized level of earnings after outperformance from our mortgage banking operations and higher than usual gains from portfolio optimization in the first quarter. While many companies in our sector experienced book value declines in the second quarter as benchmark interest rates continued to rise, our credit-focused model and hedging strategy helped deliver our ninth consecutive quarterly book value increase.

Further, this increase was after paying a second quarter \$0.30 per share dividend, which represented a 7% increase from our first quarter dividend.

Investment Portfolio

During the second quarter, we continued to optimize our investment portfolio, selling lower-yielding securities and accelerating the deployment of capital into higher-yielding alternatives, including our new initiatives. Inclusive of the impact of our portfolio hedges, we saw increases in net interest income, resulting from both increased capital deployment and these optimization activities. On a hedge-adjusted basis, portfolio fair values were relatively flat overall during the quarter, with some marginal benefit from spread tightening in parts of our portfolio. Meanwhile, credit fundamentals in our portfolio remained strong, benefiting from continued housing price growth and improvements in the general economy.

Mortgage Banking

Loan purchase volumes in the second quarter increased 8% from the prior quarter and 60% from the same quarter last year, with expanded-prime Choice loans representing about one-third of our loan purchase commitments. Gross margins, which were well above our long-term expected run rate in the first quarter, fell within our long-term expected range in the second quarter as securitization pricing weakened, driven primarily by increased supply in the market. During the second quarter, we completed three traditional Select securitizations and one Choice securitization (our fourth since the inception of our Choice program).

Financial and Operational Overview - Second Quarter of 2018

Highlights

Our GAAP earnings were \$0.38 per share for the second quarter of 2018, as compared with \$0.50 per share for the first quarter of 2018. This change was driven primarily by mortgage banking margins which were consistent with our long-term expectations, but lower relative to the first quarter, and fewer realized gains relative to the first quarter.

Our GAAP book value was \$16.23 per share at June 30, 2018, an increase of \$0.11 per share from the first quarter, and represented an economic return of 2.5% for the quarter (economic return on book value is based on the change in GAAP book value per common share plus the dividend declared per common share during the quarter). This increase was driven primarily by our quarterly earnings exceeding our dividend and an increase in the value of our long-term debt hedge.

We deployed \$186 million of capital in the second quarter of 2018 toward new investments, including \$66 million in Sequoia and third-party RMBS, \$65 million in Agency residential CRT securities, and \$6 million in Agency multifamily securities. Additionally, we deployed \$50 million into new initiatives, including \$40 million in customized financing for our jumbo loan sellers and \$10 million to acquire a minority interest in business-purpose lender 5 Arches, LLC.

We sold \$108 million of securities during the second quarter of 2018, generating \$91 million of capital for reinvestment after the repayment of associated debt.

We purchased \$1.95 billion of residential jumbo loans during the second quarter of 2018. At June 30, 2018, our pipeline of jumbo residential loans identified for purchase was \$1.27 billion.

Residential loan sales totaled \$1.94 billion during the second quarter of 2018 and included \$1.66 billion of loans that were securitized and \$0.28 billion of whole loan sales to third parties.

We issued \$200 million of six-year, 5.625% convertible debt during the second quarter of 2018.

Our recourse debt to equity leverage ratio was 3.4x at the end of the second quarter of 2018.

In late July, we raised \$117 million of equity capital in our first follow-on stock offering since 2009.

Key Earnings Metrics

The following table presents key earnings metrics for the three and six months ended June 30, 2018.

Table 1 – Key Earnings and Return Metrics

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018		
(In Thousands, except per Share Data)				
Net income	\$32,747	\$79,592		
Net income per diluted common share	\$0.38	\$0.88		
Annualized GAAP return on equity	11	% 13	%	
REIT taxable income per share	\$0.35	\$0.79		
Dividends per share	\$0.30	\$0.58		

A detailed discussion of our second quarter of 2018 net income is included in the Results of Operations section of this MD&A that follows.

Book Value per Share

At June 30, 2018, our book value was \$1.23 billion, or \$16.23 per share, an increase from \$16.12 per share at March 31, 2018. The following table sets forth the changes in our book value per share for the three and six months ended June 30, 2018.

Table 2 – Changes in Book Value per Share

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
(In Dollars, per share basis)		
Beginning book value per share	\$16.12	\$15.83
Net income	0.38	0.88
Changes in unrealized gains on securities, net, from:		
Realized gains recognized in net income	(0.05)	(0.14)
Amortization income recognized in net income	(0.04)	(0.08)
Mark-to-market adjustments, net	0.01	0.01
Total change in unrealized gains on securities, net	(0.08)	(0.21)
Dividends	(0.30)	(0.58)
Share repurchases	—	0.01
Equity compensation, net	0.03	0.06
Changes in unrealized losses on derivatives hedging long-term debt	0.05	0.16
Other, net	0.03	0.08
Ending Book Value per Share	\$16.23	\$16.23

Our GAAP book value per share increased \$0.11 per share to \$16.23 per share during the second quarter of 2018. This increase was driven primarily by earnings exceeding the dividend payment and an increase in the value of our long-term debt hedge.

Unrealized gains on our available-for-sale securities decreased \$0.08 per share during the three months ended June 30, 2018. This decrease primarily resulted from \$0.05 per share of previously unrealized net gains that were realized as income from the sale of securities, as well as \$0.04 per share of discount accretion income recognized in earnings from the appreciation in the amortized cost basis of our available-for-sale securities.

Higher benchmark interest rates during the second quarter of 2018 resulted in a \$0.05 per share increase to book value due to a decrease in unrealized losses on the derivatives hedging a portion of our long-term debt. At June 30, 2018, the cumulative unrealized loss on these derivatives, which is included in our GAAP book value per share, was \$0.41 per share.

Capital Allocation Summary

This section provides an overview of our capital position and how it was allocated at June 30, 2018. A detailed discussion of our liquidity and capital resources is provided in the Liquidity and Capital Resources section of this MD&A that follows.

We use a combination of equity and corporate debt (which we collectively refer to as “capital”) to fund our business. Our total capital was \$2.00 billion at June 30, 2018, and included \$1.23 billion of equity capital and \$0.77 billion of the total \$2.77 billion of long-term debt on our consolidated balance sheet. This portion of debt included \$201 million of exchangeable debt due in 2019, \$245 million of convertible debt due in 2023, \$200 million of convertible debt due in 2024, and \$140 million of trust-preferred securities due in 2037.

We also utilize various forms of collateralized short-term and long-term debt to finance certain investments and to warehouse some of our inventory of residential loans held-for-sale. We do not consider this collateralized debt as "capital" and, therefore, it is presented separately from allocated capital in the table below. The following table presents how our capital was allocated between business segments and investment types at June 30, 2018.

Table 3 – Capital Allocation Summary

At June 30, 2018

(Dollars in Thousands)	Fair Value	Collateralized Debt	Allocated Capital	% of Total Capital	
Investment portfolio					
Residential loans ⁽¹⁾	\$2,356,356	\$(1,999,999)	\$356,357	18	%
Securities portfolio					
Third party residential securities	762,792	(241,648)	521,144	26	%
Sequoia residential securities ⁽²⁾	426,077	(152,565)	273,512	14	%
Multifamily securities ⁽³⁾	398,785	(312,681)	86,104	4	%
Total securities portfolio	1,587,654	(706,894)	880,760	44	%
Other investments	145,792	—	145,792	7	%
Other assets/(liabilities)	154,549	(56,450)	98,099	5	%
Cash and liquidity capital			308,169	N/A	
Total investment portfolio	\$4,244,351	\$(2,763,343)	1,789,177	90	%
Residential mortgage banking			210,000	10	%
Total			\$1,999,177	100	%

(1) Includes \$43 million of FHLB stock.

Sequoia residential securities presented above includes \$134 million of securities retained from our consolidated

(2) Sequoia Choice securitizations. For GAAP purposes we consolidated \$1.48 billion of residential loans and \$1.35 billion of non-recourse ABS debt associated with these retained securities.

(3) Includes \$377 million of multifamily securities, \$16 million of investment grade CMBS, and \$6 million of single-family securities.

Of our \$2.00 billion of total capital at June 30, 2018, \$1.79 billion (or 90%) was allocated to our investments with the remaining \$210 million (or 10%) allocated to our residential mortgage banking activities.

As of June 30, 2018, our cash and liquidity capital included \$200 million of capital available for investment.

Additionally, in July 2018, we raised \$117 million of capital in an underwritten public offering of our common stock.

RESULTS OF OPERATIONS

Within this Results of Operations section, we provide commentary that compares results year-over-year for 2018 and 2017. Most tables include a "change" column that shows the amount by which the results from 2018 are greater or less than the results from the respective period in 2017. Unless otherwise specified, references in this section to increases or decreases during the "three-month periods" refer to the change in results for the second quarter of 2018, compared to the second quarter of 2017, and increases or decreases in the "six-month periods" refer to the change in results for the first six months of 2018, compared to the first six months of 2017.

The following table presents the components of our net income for the three and six months ended June 30, 2018 and 2017.

Table 4 – Net Income

(In Thousands, except per Share Data)	Three Months Ended June 30,			Six Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
Net Interest Income	\$34,763	\$34,990	\$(227)	\$69,868	\$68,587	\$1,281
Non-interest Income						
Mortgage banking activities, net	10,596	12,046	(1,450)	37,172	29,650	7,522
Investment fair value changes, net	889	8,115	(7,226)	2,498	9,666	(7,168)
Other income, net	3,322	3,764	(442)	5,440	6,661	(1,221)
Realized gains, net	4,714	1,372	3,342	14,077	7,075	7,002
Total non-interest income, net	19,521	25,297	(5,776)	59,187	53,052	6,135
Operating expenses	(19,009)	(18,641)	(368)	(42,039)	(36,867)	(5,172)
Net income before income taxes	35,275	41,646	(6,371)	87,016	84,772	2,244
Provision for income taxes	(2,528)	(5,322)	2,794	(7,424)	(11,479)	4,055
Net Income	\$32,747	\$36,324	\$(3,577)	\$79,592	\$73,293	\$6,299
Diluted earnings per common share	\$0.38	\$0.43	\$(0.05)	\$0.88	\$0.85	\$0.03

Net Interest Income

Net interest income for both the three- and six-month periods benefited from higher interest income driven by higher average balances of securities in our investment portfolio and residential loans held-for-sale. It also benefited from higher returns on our investment portfolio resulting from our portfolio optimization activities. These increases were offset by higher interest expense on higher average balances and higher rates on our FHLBC borrowings and short-term facilities. We hedge our investment portfolio's exposure to interest rates and the benefit from these hedges is reported in our Investment fair value changes line item, which is discussed below. A more detailed analysis of the changes in net interest income is presented in the "Net Interest Income" section that follows.

Mortgage Banking Activities, Net

The decrease in income from mortgage banking activities during the three-month periods was predominantly due to lower gross margins in 2018, relative to 2017. The increase in income from mortgage banking activities during the six-month periods was primarily due to higher loan purchase volume. A more detailed analysis of the changes in this line item is included in Residential Mortgage Banking portion of the "Results of Operations by Segment" section that follows.

Investment Fair Value Changes, Net

Investment fair value changes, net, is primarily comprised of the change in fair values of our residential loans held-for-investment and financed with FHLB borrowings, our investment securities classified as trading, and interest rate hedges associated with each of these investments. During both the three- and six-month periods, hedge costs and the effect of principal paydowns on our investments were more than offset by the net benefit from spread tightening on our securities portfolio. While net interest income from residential loans declined in the second quarter of 2018 due to rising benchmark interest rates, the net interest expense from the hedges associated with these loans also decreased, effectively offsetting this decline. Additional detail on our investment fair value changes is included in the Investment Portfolio portion of the "Results of Operations by Segment" section that follows.

Other Income, Net

Other income is primarily comprised of income from our residential loan risk-sharing arrangements with Fannie Mae and Freddie Mac, as well as the net fee income we earn from our MSR investments and the changes in their market value and the market value of their associated derivatives. The decrease in other income for both the three- and six-month periods was primarily from a decrease in income from our MSR investments due to the sale of most of our conforming MSRs in 2017.

Realized Gains, Net

During the three and six months ended June 30, 2018, we realized gains of \$5 million and \$14 million, primarily from the sale of \$41 million and \$92 million of AFS securities, respectively, as part of our portfolio optimization. During the three and six months ended June 30, 2017, we realized gains of \$2 million and \$8 million, primarily from the sale of \$19 million and \$38 million of AFS securities, respectively. Additionally, during the three months ended June 30, 2017, we realized a \$1 million loss from the repurchase of \$37 million of convertible debt.

Operating Expenses

The increase in operating expenses during the three- and six-month periods primarily resulted from higher loan acquisition costs due to higher loan purchase volume in 2018, as well as higher expenses associated with implementing new investment initiatives.

Provision for Income Taxes

Our provision for income taxes related almost entirely to activity at our taxable REIT subsidiaries, which primarily includes our mortgage banking activities and MSR investments, as well as certain other investment and hedging activities. For the three- and six-month periods, the decrease in provision for income taxes was driven primarily by the reduction in the federal corporate tax rate in 2018 resulting from the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). For additional detail on income taxes, see the "Taxable Income and Tax Provision" section that follows.

Net Interest Income

The following tables present the components of net interest income for the three and six months ended June 30, 2018 and 2017.

Table 5 – Net Interest Income

(Dollars in Thousands)	Three Months Ended June 30, 2018			2017		
	Interest Income/ (Expense) ⁽¹⁾	Average Balance	Yield	Interest Income/ (Expense) ⁽¹⁾	Average Balance	Yield
Interest Income						
Residential loans, held-for-sale	\$12,840	\$1,127,654	4.6 %	\$8,364	\$809,231	4.1 %
Residential loans - HFI at Redwood ⁽²⁾	23,524	2,344,947	4.0 %	23,408	2,358,355	4.0 %
Residential loans - HFI at Legacy Sequoia ⁽²⁾	5,015	599,203	3.3 %	4,863	716,778	2.7 %
Residential loans - HFI at Sequoia Choice ⁽²⁾	14,135	1,192,756	4.7 %	—	—	— %
Trading securities	17,368	956,365	7.3 %	10,713	666,009	6.4 %
Available-for-sale securities	8,928	313,530	11.4 %	11,113	444,179	10.0 %
Other interest income	1,166	183,095	2.5 %	763	193,324	1.6 %
Total interest income	82,976	6,717,550	4.9 %	59,224	5,187,876	4.6 %
Interest Expense						
Short-term debt facilities	(12,666)	1,478,332	(3.4)%	(6,563)	1,039,741	(2.5)%
Short-term debt - convertible notes, net	(509)	38,530	(5.3)%	(2,787)	226,385	(4.9)%
ABS issued - Legacy Sequoia ⁽²⁾	(4,215)	589,261	(2.9)%	(3,705)	700,549	(2.1)%
ABS issued - Sequoia Choice ⁽²⁾	(12,134)	1,086,602	(4.5)%	—	—	— %
Long-term debt - FHLBC	(9,833)	1,999,999	(2.0)%	(5,071)	1,999,999	(1.0)%
Long-term debt - other	(8,856)	588,765	(6.0)%	(6,108)	379,972	(6.4)%
Total interest expense	(48,213)	5,781,489	(3.3)%	(24,234)	4,346,646	(2.2)%
Net Interest Income	\$34,763			\$34,990		

(Dollars in Thousands)	Six Months Ended June 30, 2018			2017		
	Interest Income/ (Expense) ⁽¹⁾	Average Balance	Yield	Interest Income/ (Expense) ⁽¹⁾	Average Balance	Yield
Interest Income						
Residential loans, held-for-sale	\$25,532	\$1,164,138	4.4 %	\$15,850	\$778,361	4.1 %
Residential loans - HFI at Redwood ⁽²⁾	47,317	2,370,132	4.0 %	45,446	2,304,664	3.9 %
Residential loans - HFI at Legacy Sequoia ⁽²⁾	9,826	607,803	3.2 %	9,701	736,948	2.6 %
Residential loans - HFI at Sequoia Choice ⁽²⁾	23,070	971,545	4.7 %	—	—	— %
Trading securities	33,533	937,386	7.2 %	18,930	596,236	6.3 %
Available-for-sale securities	18,458	338,261	10.9 %	22,713	451,275	10.1 %
Other interest income	1,859	211,112	1.8 %	1,212	217,359	1.1 %
Total interest income	159,595	6,600,377	4.8 %	113,852	5,084,843	4.5 %
Interest Expense						
Short-term debt facilities	(23,092)	1,424,185	(3.2)%	(11,016)	917,585	(2.4)%
Short-term debt - convertible notes, net	(3,518)	143,853	(4.9)%	(2,787)	113,818	(4.9)%
ABS issued - Legacy Sequoia ⁽²⁾	(8,067)	597,859	(2.7)%	(7,235)	719,882	(2.0)%
ABS issued - Sequoia Choice ⁽²⁾	(19,683)	880,387	(4.5)%	—	—	— %
Long-term debt - FHLBC	(17,860)	1,999,999	(1.8)%	(8,806)	1,999,999	(0.9)%
Long-term debt - other	(17,507)	582,120	(6.0)%	(15,421)	499,932	(6.2)%
Total interest expense	(89,727)	5,628,403	(3.2)%	(45,265)	4,251,216	(2.1)%
Net Interest Income	\$69,868			\$68,587		

(1) Average balances for residential loans held-for-sale, residential loans held-for-investment, and trading securities are calculated based upon carrying values, which represent estimated fair values. Average balances for available-for-sale securities and debt are calculated based upon amortized historical cost, except for ABS issued, which is based upon fair value.

Interest income from residential loans held-for-investment ("HFI") at Redwood exclude loans HFI at consolidated Sequoia entities. Interest income from residential loans - HFI at Legacy Sequoia and the interest expense from (2)ABS issued - Legacy Sequoia represent activity from our consolidated Legacy Sequoia entities. Interest income from residential loans - HFI at Sequoia Choice and the interest expense from ABS issued - Sequoia Choice represent activity from our consolidated Sequoia Choice entities.

The following table presents net interest income by segment for the three and six months ended June 30, 2018 and 2017.

Table 6 – Net Interest Income by Segment

(In Thousands)	Three Months Ended June 30,			Six Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
Net Interest Income by Segment						
Investment Portfolio	\$37,565	\$38,602	\$(1,037)	\$76,459	\$75,588	\$871
Residential Mortgage Banking	5,455	4,012	1,443	12,215	8,562	3,653
Corporate/Other	(8,257)	(7,624)	(633)	(18,806)	(15,563)	(3,243)
Net Interest Income	\$34,763	\$34,990	\$(227)	\$69,868	\$68,587	\$1,281

Additional details regarding the activities impacting net interest income at each segment are included in the "Results of Operations by Segment" section that follows.

The Corporate/Other line item in the table above primarily includes interest expense related to long-term debt not directly allocated to our segments and net interest income from consolidated Legacy Sequoia entities. The increase in corporate net interest expense during the three- and six-month periods was primarily due to the issuance of \$245 million of convertible notes in August 2017, which was partially offset by the repayment of \$250 million of convertible notes in April 2018. Additionally, net interest income from our Legacy Sequoia entities has continued to decrease as the underlying residential loans and ABS issued pay down. Details regarding consolidated Legacy Sequoia entities are included in the "Results of Consolidated Legacy Sequoia Entities" section that follows.

The following table presents the net interest rate spread between the yield on unsecuritized loans and securities and the debt yield of the short-term debt used in part to finance each investment type at June 30, 2018.

Table 7 – Interest Expense — Specific Borrowing Costs

June 30, 2018	Residential Loans Held-for-Sale		Residential Securities	
Asset yield	4.75	%	5.85	%
Short-term debt yield	3.69	%	3.25	%
Net Spread	1.06	%	2.60	%

For additional discussion on short-term debt, including information regarding margin requirements and financial covenants, see "Risks Relating to Debt Incurred under Short-Term and Long-Term Borrowing Facilities" in the Liquidity and Capital Resources section of this MD&A.

Results of Operations by Segment

We report on our business using two distinct segments: Investment Portfolio and Residential Mortgage Banking. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For additional information on our segments, refer to Note 20 of our Notes to Consolidated Financial Statements in Part I, Item I of this Quarterly Report on Form 10-Q. The following table presents the segment contribution from our two segments, reconciled to our consolidated net income, for the three and six months ended June 30, 2018 and 2017.

Table 8 – Segment Results Summary

(In Thousands)	Three Months Ended June 30,			Six Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
Segment Contribution from:						
Investment Portfolio	\$44,213	\$49,831	\$(5,618)	\$93,283	\$95,446	\$(2,163)
Residential Mortgage Banking	9,042	7,035	2,007	29,738	18,888	10,850
Corporate/Other	(20,508)	(20,542)	34	(43,429)	(41,041)	(2,388)
Net Income	\$32,747	\$36,324	\$(3,577)	\$79,592	\$73,293	\$6,299

The following sections provide a detailed discussion of the results of operations at each of our two business segments for the three and six months ended June 30, 2018 and 2017.

While the net expense from Corporate/Other was consistent for the three-month periods, the \$2 million increase for the six-month periods was due primarily to higher convertible debt interest expense.

Investment Portfolio Segment

Our Investment Portfolio segment is primarily comprised of our portfolio of residential mortgage loans held-for-investment and financed through the FHLBC and our real estate securities portfolio. Additionally, beginning in the third quarter of 2017, this segment includes residential loans held-for-investment at our consolidated Sequoia Choice entities.

The following table presents the components of segment contribution for the Investment Portfolio segment for the three and six months ended June 30, 2018 and 2017.

Table 9 – Investment Portfolio Segment Contribution

(In Thousands)	Three Months Ended June 30,			Six Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
Interest income	\$64,569	\$45,833	\$18,736	\$123,326	\$88,083	\$35,243
Interest expense	(27,004)	(7,231)	(19,773)	(46,867)	(12,495)	(34,372)
Net interest income	37,565	38,602	(1,037)	76,459	75,588	871
Non-interest income						
Investment fair value changes, net	1,600	9,115	(7,515)	3,190	12,474	(9,284)
Other income, net	3,322	3,764	(442)	5,440	6,661	(1,221)
Realized gains, net	4,714	2,124	2,590	14,077	7,827	6,250
Total non-interest income, net	9,636	15,003	(5,367)	22,707	26,962	(4,255)
Direct operating expenses	(1,858)	(1,454)	(404)	(3,865)	(3,047)	(818)
Segment contribution before income taxes	45,343	52,151	(6,808)	95,301	99,503	(4,202)
Provision for income taxes	(1,130)	(2,320)	1,190	(2,018)	(4,057)	2,039
Total Segment Contribution	\$44,213	\$49,831	\$(5,618)	\$93,283	\$95,446	\$(2,163)

The following table presents our primary portfolios of investment assets in our Investment Portfolio segment at June 30, 2018 and December 31, 2017.

Table 10 – Investment Portfolio

(In Thousands)	June 30, 2018	December 31, 2017	Change
Residential loans held-for-investment at Redwood	\$2,313,336	\$2,434,386	\$(121,050)
Residential securities	1,055,151	1,152,485	(97,334)
Commercial/Multifamily securities	398,785	324,025	74,760
Residential loans held-for-investment at Sequoia Choice ⁽¹⁾	1,481,145	620,062	861,083
Other assets	343,361	212,915	130,446
Total Assets at Investment Portfolio	\$5,591,778	\$4,743,873	\$847,905

Our economic investment in the consolidated Sequoia Choice entities at June 30, 2018 and December 31, 2017 was (1)\$135 million and \$78 million, respectively. For additional details on our Choice loans, see the subsection titled "Residential Loans Held-for-Investment at Sequoia Choice Portfolio" that follows.

Overview

During the first six months of 2018, we continued our focus on optimizing our investment portfolio by selling assets that had appreciated in value with lower current yields, and redeployed capital into higher-yielding opportunities. Our sales were mostly comprised of Agency CRT, mezzanine, and legacy securities and our purchases mostly comprised of Sequoia, multifamily securities, and third-party subordinate investments. Through these sales, we captured previously unrealized appreciation, which increased our realized gains during the three and six months ended June 30, 2018. While credit spreads continued to tighten during 2018, the benefit from spread tightening during the three and six months ended June 30, 2018 was lower than for those same periods in 2017, negatively impacting year-over-year results.

Net Interest Income

Net interest income from our Investment Portfolio primarily includes interest income from our residential loans held-for-investment and our securities, as well as the associated interest expense from short-term debt, FHLBC borrowings, and ABS issued. The following table presents the components of net interest income for our Investment Portfolio segment for the three and six months ended June 30, 2018 and 2017.

Table 11 - Net Interest Income ("NII") from Investment Portfolio

(In Thousands)	Three Months Ended June 30,			Six Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
Net interest income from:						
HFI residential loans at Redwood	\$13,685	\$18,337	\$(4,652)	\$29,457	\$36,640	\$(7,183)
HFI residential loans at Sequoia Choice	2,001	—	2,001	3,387	—	3,387
Residential securities	19,398	17,950	1,448	38,917	34,864	4,053
Commercial/Multifamily securities	1,861	1,716	145	3,750	3,090	660
Other interest income	620	599	21	948	994	(46)
NII from Investment Portfolio	\$37,565	\$38,602	\$(1,037)	\$76,459	\$75,588	\$871
Supplemental information:						
Hedge interest income (expense), net	\$25	\$(3,768)	\$3,793	\$(2,858)	\$(7,461)	\$4,603
NII and hedge interest income (expense), net	\$37,590	\$34,834	\$2,756	\$73,601	\$68,127	\$5,474

The changes in net interest income for the three- and six-month periods were due primarily to lower net interest income from residential loans, which decreased primarily as a result of higher interest costs from rising benchmark rates during the past 12 months. These decreases were offset by an increase in net interest income from real estate securities, which mostly resulted from higher average balances in addition to higher yields on these investments, and an increase in net interest income from our investments in Sequoia Choice securitizations that we consolidated for GAAP purposes.

The table above also presents net interest income (expense) from hedges that we use to manage interest rate risk in our investment portfolio and are included as a component of Investment fair value changes, net on our consolidated statements of income. Inclusive of the hedge interest, net interest income increased in both the three- and six-month periods.

Investment fair value changes, net

Market valuation changes included in Investment fair value changes, net, result from changes in the fair value of investments and their associated hedges, generally due to changes in market interest rates, changes in credit spreads, and reductions in the basis of investments due to changes in principal balances. See Note 17 of our Notes to Consolidated Financial Statements in Part I, Item I of this Quarterly Report on Form 10-Q for additional detail regarding the components of Investment fair value changes, net presented on our consolidated statements of income.

The following table presents the components of investment fair value changes for our Investment Portfolio segment, which is comprised of market valuation gains and losses by investment type, inclusive of fair value changes of associated risk management derivatives, for the three and six months ended June 30, 2018 and 2017.

Table 12 - Investment Portfolio Fair Value Changes, Net by Investment Type

(In Thousands)	Three Months Ended June 30,			Six Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
Market valuation changes:						
Residential loans held-for-investment at Redwood	\$(1,457)	\$(6,078)	\$4,621	\$(4,195)	\$(12,477)	\$8,282
Net investments in Sequoia Choice entities ⁽¹⁾	1,072	—	1,072	986	—	986
Residential trading securities	(258)	9,835	(10,093)	654	13,795	(13,141)
Commercial/Multifamily trading securities	2,508	5,997	(3,489)	6,149	12,117	(5,968)
Other valuation changes	(265)	(639)	374	(404)	(961)	557
Investment Fair Value Changes, Net	\$1,600	\$9,115	\$(7,515)	\$3,190	\$12,474	\$(9,284)

Includes changes in fair value of the residential loans held-for-investment and the ABS issued at the entities, which (1) netted together represent the change in value of our retained investments (senior and subordinate securities) at the consolidated VIEs.

During the three and six months ended June 30, 2018 and 2017, the negative investment fair value changes from loans and their associated derivatives primarily resulted from hedging costs, which decreased year-over-year due to rising interest rates. The increase in fair values from securities and their associated derivatives during both periods primarily resulted from tighter spreads on these investments, partially offset by hedging costs and decreases in fair value from reductions in the basis of IO securities from associated principal repayments.

Other Income, net

The following table presents the components of MSR income, net for the three and six months ended June 30, 2018 and 2017.

Table 13 – MSR Income, net

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net servicing fee income	\$3,464	\$5,852	\$6,667	\$11,379
Changes in fair value of MSR from the receipt of expected cash flows	(1,688)	(3,065)	(3,142)	(5,478)
MSR reversal of provision for repurchases	277	307	277	312
MSR income before the effect of changes in interest rates and other assumptions	2,053	3,094	3,802	6,213
Changes in fair value of MSRs from interest rates and other assumptions ⁽¹⁾	943	(3,356)	5,289	(4,013)
Changes in fair value of associated derivatives	(1,122)	3,040	(6,261)	2,291
Total net effect of changes in assumptions and rates	(179)	(316)	(972)	(1,722)
MSR Income, Net ⁽²⁾	\$1,874	\$2,778	\$2,830	\$4,491

(1) Primarily reflects changes in prepayment assumptions on our MSRs due to changes in benchmark interest rates.

(2) MSR income, net is included in Other income, net on our consolidated statements of income.

MSR income declined for the first six months of 2018 as compared with the same period last year, primarily due to the sale of most of our conforming MSRs in 2017.

Realized Gains, net

During the three months ended June 30, 2018, we realized gains of \$5 million, primarily from the sale of \$41 million of AFS securities. During the three months ended June 30, 2017, we realized gains of \$2 million, primarily from the sale of \$19 million of AFS securities.

Direct Operating Expenses and Provision for Income Taxes

The increase in operating expenses at our Investment Portfolio segment for the three- and six-month periods was primarily attributable to higher compensation expense, as we added resources to support our single-family rental and multifamily investments.

The provision for income taxes at our Investment Portfolio segment primarily results from GAAP income earned at our TRS from MSRs and certain securities. For the three- and six-month periods, the decrease in the tax provision primarily resulted from the reduction of the federal corporate tax rate due to the Tax Act.

Residential Loans Held-for-Investment at Redwood Portfolio

The following table provides the activity of residential loans held-for-investment at Redwood during the three and six months ended June 30, 2018 and 2017.

Table 14 – Residential Loans Held-for-Investment at Redwood - Activity

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
(In Thousands)		
Fair value at beginning of period	\$2,375,785	\$2,434,386
Transfers between portfolios ⁽¹⁾	31,936	87,711
Principal repayments	(79,375)	(154,329)
Changes in fair value, net	(15,010)	(54,432)
Fair Value at End of Period	\$2,313,336	\$2,313,336

⁽¹⁾ Represents the net transfers of loans into our Investment Portfolio segment from our Residential Mortgage Banking segment and their reclassification from held-for-sale to held-for-investment.

The decrease in the balance of loans held-for-investment during the three months ended June 30, 2018 was primarily due to principal repayments and a decrease in fair value of the loans during this period, resulting from rising benchmark interest rates. As our loans held-for-investment are generally fixed-rate and sensitive to changes in interest rates, we utilize various interest rate derivatives to hedge our interest rate risk for these investments. As a result of rising interest rates during the three and six months ended June 30, 2018, interest rate derivatives associated with these investments increased in value by \$14 million and \$50 million, respectively.

At June 30, 2018, \$2.31 billion of loans were held by our FHLB-member subsidiary and were financed with \$2.00 billion of borrowings from the FHLBC. In connection with these borrowings, our FHLB-member subsidiary is required to hold \$43 million of FHLB stock.

At June 30, 2018, the weighted average maturity of these FHLB borrowings was approximately seven years and they had a weighted average cost of 2.03% per annum. This interest cost resets every 13 weeks and we seek to fix the interest cost of these FHLB borrowings over their weighted average maturity by using a combination of swaps, TBAs and other derivatives.

Under a final rule published by the Federal Housing Finance Agency in January 2016, our FHLB-member subsidiary will remain an FHLB member through the five-year transition period for captive insurance companies. Our FHLB-member subsidiary's existing \$2.00 billion of FHLB debt, which matures beyond this transition period, is permitted to remain outstanding until its stated maturity. As residential loans pledged as collateral for this debt pay down, we are permitted to pledge additional loans or other eligible assets to collateralize this debt; however, we do not expect to be able to increase our subsidiary's FHLB debt above the existing \$2.00 billion.

The following table presents the unpaid principal balances for residential real estate loans held-for-investment at fair value by product type at June 30, 2018.

Table 15 – Characteristics of Residential Real Estate Loans Held-for-Investment at Redwood June 30, 2018

(Dollars in Thousands)	Principal Balance	Weighted Average Coupon
Fixed - 30 year	\$2,042,044	4.09 %
Fixed - 15, 20, & 25 year	66,031	3.66 %
Hybrid	233,292	4.09 %
Total Outstanding Principal	\$2,341,367	

The outstanding loans held-for-investment at Redwood at June 30, 2018 were prime-quality, first lien loans, of which 96% were originated between 2013 and 2018 and 4% were originated in 2012 and prior years. The weighted average FICO score of borrowers backing these loans was 770 (at origination) and the weighted average loan-to-value ("LTV") ratio was 66% (at origination). At June 30, 2018, three of these loans with a total unpaid principal balance of \$1 million were greater than 90 days delinquent and none of these loans were in foreclosure.

Real Estate Securities Portfolio

The following table sets forth our real estate securities activity by collateral type in our Investment Portfolio segment for the three and six months ended June 30, 2018.

Table 16 – Real Estate Securities Activity by Collateral Type

Three Months Ended June 30, 2018	Residential			Commercial (2)	Total
(In Thousands)	Senior (1)	Mezzanine	Subordinate	Mezzanine	
Beginning fair value	\$247,672	\$228,114	\$504,926	\$377,008	\$1,357,720
Acquisitions					
Sequoia securities	10,866	14,204	2,047	—	27,117
Third-party securities	49,031	28,964	88,101	29,809	195,905
Sales					
Sequoia securities	—	(28,661)	—	—	(28,661)
Third-party securities	(10,409)	—	(64,320)	(4,969)	(79,698)
Gains on sales and calls, net	2,401	2,273	40	—	4,714
Effect of principal payments (3)	(8,612)	(2,389)	(2,685)	(3,376)	(17,062)
Change in fair value, net	(5,130)	(3,398)	2,116	313	(6,099)
Ending Fair Value (4)	\$285,819	\$239,107	\$530,225	\$398,785	\$1,453,936

Six Months Ended June 30, 2018 (In Thousands)	Residential			Commercial (2)	Total
	Senior (1)	Mezzanine	Subordinate	Mezzanine	
Beginning fair value	\$249,838	\$331,452	\$571,195	\$324,025	\$1,476,510
Acquisitions					
Sequoia securities	23,357	14,204	5,952	—	43,513
Third-party securities	49,031	40,308	121,539	113,096	323,974
Sales					
Sequoia securities	—	(54,743)	(12,052)	—	(66,795)
Third-party securities	(19,564)	(81,432)	(152,808)	(31,632)	(285,436)
Gains on sales and calls, net	4,893	4,354	4,830	—	14,077
Effect of principal payments (3)	(15,960)	(5,200)	(5,047)	(6,562)	(32,769)
Change in fair value, net	(5,776)	(9,836)	(3,384)	(142)	(19,138)
Ending Fair Value (4)	\$285,819	\$239,107	\$530,225	\$398,785	\$1,453,936

(1) Includes \$34 million of re-REMIC securities at June 30, 2018.

(2) Our commercial securities are primarily comprised of Agency multifamily securities.

The effect of principal payments reflects the change in fair value due to principal payments, which is calculated as (3) the cash principal received on a given security during the period multiplied by the prior quarter ending price or acquisition price for that security.

Excludes \$134 million of securities retained from our consolidated Sequoia Choice securitizations at June 30,

(4) 2018. For additional details on our Choice loans, see the subsection titled "Residential Loans Held-for-Investment at Sequoia Choice Portfolio" that follows.

During the three and six months ended June 30, 2018, we sold \$108 million and \$352 million, respectively, of mostly lower-yielding securities as part of our ongoing portfolio optimization activities.

At June 30, 2018, our securities consisted of fixed-rate assets (65%), adjustable-rate assets (28%), hybrid assets that reset within the next year (6%), and hybrid assets that reset between 12 and 36 months (1%). For the portions of our securities portfolio that are sensitive to changes in interest rates, we seek to minimize this interest rate risk by using various derivative instruments.

We directly finance our holdings of real estate securities with a combination of capital and collateralized debt in the form of repurchase (or “repo”) financing. The following table presents the fair value of our residential securities that were financed with repurchase debt at June 30, 2018.

Table 17 – Real Estate Securities Financed with Repurchase Debt
June 30, 2018

(Dollars in Thousands, except Weighted Average Price)	Real Estate Securities (1)	Repurchase Debt	Allocated Capital	Weighted Average Price ⁽²⁾	Financing Haircut ⁽³⁾
Residential Securities					
Senior	\$ 161,038	\$(142,106)	\$18,932	\$ 98	12 %
Mezzanine ⁽⁴⁾	292,571	(252,107)	40,464	96	14 %
Total Residential Securities	453,609	(394,213)	59,396	95	13 %
Commercial/Multifamily Securities	392,383	(312,681)	79,702	96	20 %
Total	\$ 845,992	\$(706,894)	\$ 139,098		

(1) Amounts represent carrying value of securities, which are held at GAAP fair value.

(2) GAAP fair value per \$100 of principal.

(3) Allocated capital divided by GAAP fair value.

(4) Includes \$88 million of securities retained from our consolidated Sequoia Choice securitizations at June 30, 2018. At June 30, 2018, we had short-term debt incurred through repurchase facilities of \$707 million, which was secured by \$846 million of real estate securities. The remaining \$742 million of our securities, including certain securities retained from our consolidated Sequoia Choice securitizations, were financed with capital. Our repo borrowings were made under facilities with seven different counterparties, and the weighted average cost of funds for these facilities during the second quarter of 2018 was approximately 3.20% per annum.

At June 30, 2018, the securities we financed through repurchase facilities had no material credit issues. In addition to the allocated capital listed in the table above that directly supports our repurchase facilities (the “financing haircut”), we continue to hold a designated amount of supplemental risk capital available for potential margin calls or future obligations relating to these facilities.

The majority of the \$161 million of senior securities noted in the table above are supported by seasoned residential loans originated prior to 2008. The \$293 million of mezzanine securities financed through repurchase facilities at June 30, 2018 carry investment grade credit ratings and are supported by residential loans originated between 2012 and 2018. The loans underlying these securities have experienced minimal delinquencies to date. The \$392 million of multifamily securities financed through repurchase facilities at June 30, 2018 carry investment grade credit ratings with 7%-8% of structural credit enhancement.

The following table presents our real estate securities at June 30, 2018 and December 31, 2017, categorized by portfolio vintage (the years the securities were issued), and by priority of cash flows (senior, mezzanine, and subordinate). We have additionally separated securities issued through our Sequoia platform or by third parties, including the Agencies.

Table 18 – Real Estate Securities by Vintage and Type

June 30, 2018	Sequoia 2012-2018	Third Party 2013-2018	Agency CRT 2013-2018	Third Party <=2008	Total Residential Securities	Commercial 2015-2018	Total Real Estate Securities
Senior ⁽¹⁾⁽²⁾	\$ 59,628	\$ 76,848	\$ —	\$ 149,343	\$ 285,819	\$ —	\$ 285,819
Mezzanine ⁽³⁾	101,192	137,915	—	—	239,107	398,785	637,892
Subordinate ⁽¹⁾	131,539	140,969	239,767	17,950	530,225	—	530,225
Total Securities ⁽⁴⁾	\$ 292,359	\$ 355,732	\$ 239,767	\$ 167,293	\$ 1,055,151	\$ 398,785	\$ 1,453,936

December 31, 2017 (In Thousands)	Sequoia 2012-2017	Third Party 2013-2017	Agency CRT 2013-2017	Third Party <=2008	Total Residential Securities	Commercial 2015-2017	Total Real Estate Securities
Senior ⁽¹⁾⁽²⁾	\$ 33,773	\$ 33,517	\$ —	\$ 182,548	\$ 249,838	\$ —	\$ 249,838
Mezzanine ⁽³⁾	147,466	183,985	—	—	331,451	324,025	655,476
Subordinate ⁽¹⁾	139,442	108,455	300,713	22,586	571,196	—	571,196
Total Securities ⁽⁴⁾	\$ 320,681	\$ 325,957	\$ 300,713	\$ 205,134	\$ 1,152,485	\$ 324,025	\$ 1,476,510

At June 30, 2018 and December 31, 2017, senior Sequoia and third-party securities included \$89 million and \$70 (1) million of IO securities, respectively. At both June 30, 2018 and December 31, 2017, subordinate third-party securities included \$12 million of IO securities.

Our interest-only securities included \$39 million and \$15 million of A-IO-S securities at June 30, 2018 and December 31, 2017, respectively, which are securities we retained from certain of our Sequoia securitizations.

(2) These securities represent certificated servicing strips and therefore may be negatively impacted by the operating and funding costs related to servicing the associated securitized mortgage loans.

(3) Mezzanine includes securities initially rated AA through BBB- and issued in 2012 or later.

Excludes \$134 million and \$78 million of securities retained from our consolidated Sequoia Choice securitizations (4) at June 30, 2018 and December 31, 2017, respectively. For GAAP purposes we consolidated \$1.48 billion of residential loans and \$1.35 billion of non-recourse ABS debt associated with these retained securities.

The following tables present the components of the interest income we earned on AFS securities for the three and six months ended June 30, 2018 and 2017.

Table 19 – Interest Income — AFS Securities

Three Months Ended June 30, 2018

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of			
					Interest Income	Discount (Premium) Amortization	Total Interest Income	
Residential								
Senior	\$ 1,741	\$ 2,185	\$ 3,926	\$ 116,862	5.96 %	7.48 %		13.44 %
Mezzanine	532	226	758	49,951	4.26 %	1.81 %		6.07 %
Subordinate	2,807	1,437	4,244	146,717	7.65 %	3.92 %		11.57 %
Total AFS Securities	\$ 5,080	\$ 3,848	\$ 8,928	\$ 313,530	6.48 %	4.91 %		11.39 %

Three Months Ended June 30, 2017

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of			
					Interest Income	Discount (Premium) Amortization	Total Interest Income	
Residential								
Senior	\$ 2,173	\$ 2,812	\$ 4,985	\$ 158,659	5.48 %	7.09 %		12.57 %
Mezzanine	1,263	614	1,877	131,574	3.84 %	1.87 %		5.71 %
Subordinate	2,872	1,379	4,251	153,946	7.46 %	3.58 %		11.04 %
Total AFS Securities	\$ 6,308	\$ 4,805	\$ 11,113	\$ 444,179	5.68 %	4.33 %		10.01 %

Six Months Ended June 30, 2018

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of			
					Interest Income	Discount (Premium) Amortization	Total Interest Income	
Residential								
Senior	\$ 3,567	\$ 4,671	\$ 8,238	\$ 123,924	5.76 %	7.54 %		13.30 %
Mezzanine	1,298	542	1,840	61,467	4.22 %	1.76 %		5.98 %
Subordinate	5,685	2,695	8,380	152,870	7.44 %	3.53 %		10.97 %
Total AFS Securities	\$ 10,550	\$ 7,908	\$ 18,458	\$ 338,261	6.24 %	4.68 %		10.92 %

Six Months Ended June 30, 2017

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of		
					Interest Income	Discount (Premium) Amortization	Total Interest Income
Residential							
Senior	\$4,382	\$ 5,928	\$10,310	\$ 161,987	5.41 %	7.32 %	12.73 %
Mezzanine	2,682	1,268	3,950	139,538	3.84 %	1.82 %	5.66 %
Subordinate	5,583	2,870	8,453	149,750	7.46 %	3.83 %	11.29 %
Total AFS Securities	\$12,647	\$ 10,066	\$22,713	\$ 451,275	5.61 %	4.46 %	10.07 %

Residential Loans Held-for-Investment at Sequoia Choice Portfolio

During the second half of 2017 and the first half of 2018, we issued four securitizations primarily comprised of expanded-prime Choice loans. We consolidate the Sequoia Choice securitization entities for financial reporting purposes in accordance with GAAP. These entities are independent of Redwood and the assets and liabilities of these entities are not, respectively, owned by us or legal obligations of ours. We record the assets and liabilities of the consolidated Sequoia Choice entities at fair value, based on the estimated fair value of the debt securities (ABS) issued from the securitizations, in accordance with GAAP provisions for collateralized financing entities. At June 30, 2018, the estimated fair value of our economic investments in the consolidated Sequoia Choice entities was \$135 million, and was comprised of retained senior and subordinate securities.

The following tables present the statements of income for the three and six months ended June 30, 2018 and 2017 and the balance sheets of the consolidated Sequoia Choice entities at June 30, 2018 and December 31, 2017. All amounts in the statements of income and balance sheets presented below are included in our consolidated financial statements and are included in our Investment Portfolio segment.

Table 20 – Consolidated Sequoia Choice Entities Statements of Income

(In Thousands)	Three Months Ended June 30,			Six Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
Interest income	\$14,135	\$ —	—\$14,135	\$23,070	\$ —	—\$23,070
Interest expense	(12,134)	—	(12,134)	(19,683)	—	(19,683)
Net interest income	2,001	—	2,001	3,387	—	3,387
Investment fair value changes, net	1,073	—	1,073	987	—	987
Net Income from Consolidated Sequoia Choice Entities	\$3,074	\$ —	—\$3,074	\$4,374	\$ —	—\$4,374

Table 21 – Consolidated Sequoia Choice Entities Balance Sheets

(In Thousands)	June 30, 2018	December 31, 2017
Residential loans, held-for-investment, at fair value	\$1,481,145	\$620,062
Other assets	5,966	2,528
Total Assets	\$1,487,111	