REDWOOD TRUST INC
Form 10-Q
November 08, 2016

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: September 30, 2016

OR

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

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

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

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

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

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

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

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

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 76,656,828 shares outstanding as of October 31, 2016

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2016 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)	September 30, 2016	December 31, 2015
ASSETS [1]		
Residential loans, held-for-sale, at fair value	$ 1,188,514	$ 1,115,738
Residential loans, held-for-investment, at fair value	3,122,650	2,813,065
Commercial loans, held-for-sale (includes $0 and $39,141 at fair value)	30,400	39,141
Commercial loans, held-for-investment (includes $0 and $67,657 at fair value)	—	363,506
Real estate securities, at fair value	936,910	1,233,256
Mortgage servicing rights, at fair value	106,009	191,976
Cash and cash equivalents	221,372	220,229
Total earning assets	5,605,855	5,976,911
Restricted cash	2,044	5,567
Accrued interest receivable	20,054	23,290
Derivative assets	36,880	16,393
Other assets	207,786	197,886
Total Assets	$ 5,872,619	$ 6,220,047
LIABILITIES AND EQUITY [1]		
Liabilities		
Short-term debt	$ 1,117,405	$ 1,855,003
Accrued interest payable	15,518	8,936
Derivative liabilities	100,117	62,794
Accrued expenses and other liabilities	69,708	69,897
Asset-backed securities issued (includes $819,868 and $996,820 at fair value), net [2]	819,868	1,049,415
Long-term debt (includes $0 and $63,152 at fair value), net [2]	2,619,873	2,027,737
Total liabilities	4,742,489	5,073,782
Equity		
Common stock, par value $0.01 per share, 180,000,000 shares authorized; 76,682,333 and 78,162,765 issued and outstanding	767	782
Additional paid-in capital	1,677,623	1,695,956
Accumulated other comprehensive income	54,715	91,993
Cumulative earnings	1,124,580	1,018,683
Cumulative distributions to stockholders	(1,727,555)	(1,661,149)
Total equity	1,130,130	1,146,265
Total Liabilities and Equity	$ 5,872,619	$ 6,220,047

(1) Our consolidated balance sheets include assets of consolidated variable interest entities ("VIEs") that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to Redwood Trust, Inc. or its affiliates. At September 30, 2016 and December 31, 2015, assets of consolidated VIEs totaled $847,399 and $1,195,574, respectively. At September 30, 2016 and December 31, 2015, liabilities of consolidated VIEs totaled $820,391 and $1,050,861, respectively. See Note 4 for further discussion.

(2) At September 30, 2016 and December 31, 2015, Asset-backed securities issued, net included $0 and $542, respectively, of deferred debt issuance costs, and long-term debt, net included $7,891 and $10,438, respectively, of deferred debt issuance costs.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, except Share Data)	Three Months Ended September 30,		Nine Months Ended September 30,	
(Unaudited)	2016	2015	2016	2015
Interest Income				
Residential loans	$35,595	$ 29,472	$102,149	$ 80,289
Commercial loans	6,453	11,191	28,834	34,784
Real estate securities	18,600	22,749	58,112	75,363
Other interest income	258	72	926	167
Total interest income	60,906	63,484	190,021	190,603
Interest Expense				
Short-term debt	(5,405)	(7,627)	(17,439)	(21,378)
Asset-backed securities issued	(3,193)	(5,190)	(11,457)	(17,037)
Long-term debt	(12,999)	(11,058)	(39,095)	(32,429)
Total interest expense	(21,597)	(23,875)	(67,991)	(70,844)
Net Interest Income	39,309	39,609	122,030	119,759
Reversal of provision for loan losses	859	60	7,102	115
Net Interest Income after Provision	40,168	39,669	129,132	119,874
Non-interest Income (loss)				
Mortgage banking activities, net	9,766	1,333	24,712	10,706
Mortgage servicing rights income (loss), net	3,770	3,549	12,834	(6,545)
Investment fair value changes, net	11,918	(14,169)	(18,686)	(17,105)
Other income	1,643	327	4,157	2,435
Realized gains, net	6,615	5,548	26,037	16,170
Total non-interest income (loss), net	33,712	(3,412)	49,054	5,661
Operating expenses	(20,355)	(24,497)	(70,962)	(74,778)
Net Income before Provision for Income Taxes	53,525	11,760	107,224	50,757
(Provision for) benefit from income taxes	(972)	7,404	(1,327)	10,272
Net Income	$52,553	$ 19,164	$105,897	$ 61,029
Basic earnings per common share	$0.67	$ 0.22	$1.34	$ 0.71
Diluted earnings per common share	$0.58	$ 0.22	$1.23	$ 0.69
Regular dividends declared per common share	$0.28	$ 0.28	$0.84	$ 0.84
Basic weighted average shares outstanding	76,680,183	83,787,533	76,827,026	83,696,461
Diluted weighted average shares outstanding	97,831,617	85,074,704	97,991,678	85,338,996

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 Ended September 30,		Nine Months Ended September 30,	
(Unaudited)	2016	2015	2016	2015
Net Income	$52,553	$19,164	$105,897	$61,029
Other comprehensive income (loss):				
Net unrealized gain (loss) on available-for-sale securities	9,038	(5,673)	5,195	(5,701)
Reclassification of unrealized gain on available-for-sale securities to net income	(1,319)	(3,270)	(19,983)	(10,320)
Net unrealized gain (loss) on interest rate agreements	647	(12,049)	(22,545)	(5,023)
Reclassification of unrealized loss on interest rate agreements to net income	18	19	55	77
Total other comprehensive income (loss)	8,384	(20,973)	(37,278)	(20,967)
Total Comprehensive Income	$60,937	$(1,809)	$68,619	$40,062

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 Nine Months Ended September 30, 2016

(In Thousands, except Share Data)	Common Stock		Additional Paid-In	Accumulated Other	Cumulative	Cumulative Distributions	Total
(Unaudited)	Shares	Amount	Capital	Comprehensive Income	Earnings	to Stockholders	
December 31, 2015	78,162,765	$ 782	$ 1,695,956	$ 91,993	$ 1,018,683	$ (1,661,149)	$ 1,146,265
Net income	—	—	—	—	105,897	—	105,897
Other comprehensive loss	—	—	—	(37,278)	—	—	(37,278)
Employee stock purchase and incentive plans	437,441	4	(4,183)	—	—	—	(4,179)
Non-cash equity award compensation	—	—	10,595	—	—	—	10,595
Share repurchases	(1,917,873)	(19)	(24,745)	—	—	—	(24,764)
Common dividends declared	—	—	—	—	—	(66,406)	(66,406)
September 30, 2016	76,682,333	$ 767	$ 1,677,623	$ 54,715	$ 1,124,580	$ (1,727,555)	$ 1,130,130

For the Nine Months Ended September 30, 2015

(In Thousands, except Share Data)	Common Stock		Additional Paid-In	Accumulated Other	Cumulative	Cumulative Distributions	Total
(Unaudited)	Shares	Amount	Capital	Comprehensive Income	Earnings	to Stockholders	
December 31, 2014	83,443,141	$ 834	$ 1,774,030	$ 140,688	$ 906,867	$ (1,566,278)	$ 1,256,141
Cumulative effect adjustment - adoption of ASU 2014-13 (1)	—	—	—	—	9,728	—	9,728
January 1, 2015	83,443,141	834	1,774,030	140,688	916,595	(1,566,278)	1,265,869
Net income	—	—	—	—	61,029	—	61,029
Other comprehensive income	—	—	—	(20,967)	—	—	(20,967)
Dividend reinvestment & stock purchase plans	418,508	4	6,830	—	—	—	6,834
Employee stock purchase and incentive plans	714,801	7	(7,735)	—	—	—	(7,728)
Non-cash equity award compensation	—	—	9,002	—	—	—	9,002
Share repurchases	(2,451,523)	(24)	(35,352)	—	—	—	(35,376)
Common dividends declared	—	—	—	—	—	(72,088)	(72,088)
September 30, 2015	82,124,927	$ 821	$ 1,746,775	$ 119,721	$ 977,624	$ (1,638,366)	$ 1,206,575

(1) On January 1, 2015, we adopted ASU 2014-13, "Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity," and recorded this cumulative-effect adjustment, which represents the net effect of adjusting the assets and liabilities of the consolidated Sequoia collateralized financing entities ("CFEs") from amortized historical cost to fair value.

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)	Nine Months Ended September 30, 2016	2015
Cash Flows From Operating Activities:		
Net income	$105,897	$61,029
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(20,251)	(26,244)
Depreciation and amortization of non-financial assets	849	510
Purchases of held-for-sale loans	(3,817,445)	(8,794,939)
Proceeds from sales of held-for-sale loans	2,930,641	7,741,024
Principal payments on held-for-sale loans	55,694	46,952
Net settlements of derivatives	(13,914)	(47,002)
Provision for loan losses	(7,102)	(115)
Non-cash equity award compensation expense	10,595	9,002
Market valuation adjustments	9,238	40,546
Realized gains, net	(26,037)	(16,170)
Net change in:		
Accrued interest receivable and other assets	7,983	(90,605)
Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities	7,728	26,094
Net cash used in operating activities	(756,124)	(1,049,918)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	—	(22,219)
Proceeds from sales of loans held-for-investment	219,639	—
Principal payments on loans held-for-investment	574,037	359,714
Purchases of real estate securities	(212,364)	(66,601)
Proceeds from sales of real estate securities	482,716	309,101
Principal payments on real estate securities	60,978	103,664
Purchase of mortgage servicing rights	(15,286)	(23,315)
Proceeds from sales of mortgage servicing rights	35,717	17,235
Net change in restricted cash	3,523	(7,733)
Net cash provided by investing activities	1,148,960	669,846
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	3,156,642	6,213,505
Repayments on short-term debt	(3,894,240)	(6,160,226)
Repayments on asset-backed securities issued	(208,801)	(256,614)
Deferred securities issuance costs	—	(33)
Proceeds from issuance of long-term debt	771,287	1,156,396
Repayments on long-term debt	(118,146)	(502,268)
Net settlements of derivatives	(119)	(32)
Net proceeds from issuance of common stock	220	7,198
Net payments on repurchase of common stock	(27,731)	(32,042)
Taxes paid on equity award distributions	(4,399)	(8,092)
Dividends paid	(66,406)	(72,088)
Net cash (used in) provided by financing activities	(391,693)	345,704
Net increase (decrease) in cash and cash equivalents	1,143	(34,368)
Cash and cash equivalents at beginning of period	220,229	269,730
Cash and cash equivalents at end of period	$221,372	$235,362
Supplemental Cash Flow Information:		

Cash paid during the period for:		
Interest	$62,053	$57,998
Taxes	826	55
Supplemental Noncash Information:		
Real estate securities retained from loan securitizations	$3,673	$39,698
Retention of mortgage servicing rights from loan securitizations and sales	7,679	52,297
Transfers from loans held-for-sale to loans held-for-investment	877,744	964,013
Transfers from loans held-for-investment to loans held-for-sale	359,005	66,918
Transfers from residential loans to real estate owned	8,479	5,740

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2016
(Unaudited)

Note 1. Organization

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

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

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2016 and December 31, 2015, and for the three and nine months ended September 30, 2016 and 2015. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with consolidated financial statements and notes thereto included in the company's Annual Report on Form 10-K for the year ended December 31, 2015. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at September 30, 2016 and results of operations for all periods presented have been made. The results of operations for the three and nine months ended September 30, 2016 should not be construed as indicative of the results to be expected for the full year.

In the second quarter of 2015, we began to specifically identify derivatives that are used to hedge our exposure to market interest rate risk associated with our mortgage servicing right ("MSR") investments. As a result, beginning in the second quarter of 2015, we changed our income statement presentation to include the change in market value of these derivatives in the line item “Mortgage servicing rights income (loss), net.” As we previously managed our market interest rate risk on a portfolio-wide basis and did not necessarily rely on derivatives to hedge our MSRs, we cannot conform prior periods to the current presentation. Therefore, in periods prior to the second quarter of 2015 presented in our consolidated statements of income, amounts in “Mortgage servicing rights income (loss), net” do not reflect the impact of hedging. These changes and year-over-year comparisons are discussed in further detail in Part I, Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations in this Quarterly Report on Form 10-Q.

Additionally, in the first quarter of 2016, we began to present the changes in fair value of certain investments and their associated derivatives in the new line item "Investment fair value changes, net" on our consolidated statements of income and began to present income from mortgage banking activities in "Mortgage banking activities, net" on our consolidated statements of income. We conformed the presentation of prior periods related to this change for consistency of comparison. See Notes 18 and 19 for additional detail on the components of these income statement line items.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2016
(Unaudited)
Note 2. Basis of Presentation - (continued)

Principles of Consolidation

In accordance with GAAP, we determine whether we must consolidate transferred financial assets and variable interest entities ("VIEs") for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities where we maintain an ongoing involvement. From its creation in 2012 through the second quarter of 2016, when the third party financing was repaid, we consolidated the assets and liabilities of an entity formed in connection with a commercial securitization we engaged in ("Commercial Securitization"). We also consolidated the assets and liabilities of an entity formed in connection with a resecuritization transaction we engaged in ("Residential Resecuritization") from its creation in 2011 through the fourth quarter of 2015, when the debt of the entity was repaid, the assets of the entity were distributed to us, and the entity was dissolved. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

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

Use of Estimates

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

Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies

Included in Note 3 to the Consolidated Financial Statements of our 2015 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company's consolidated financial condition and results of operations for the three and nine months ended September 30, 2016.

Recent Accounting Pronouncements

Newly Adopted Accounting Standards Updates ("ASUs")

In April 2015, the FASB issued ASU 2015-05, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud-Computing Arrangement." This new guidance provides additional guidance on accounting for fees paid in a cloud-computing arrangement that contains a software license. This new guidance is effective for fiscal years beginning after December 15, 2015. We adopted this guidance, as required, in the first quarter of 2016, which did not have a material impact on our consolidated financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2016
(Unaudited)

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

In April 2015, the FASB issued ASU 2015-03, “Simplifying the Presentation of Debt Issuance Costs.” This new guidance requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount. This new guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years, and is required to be applied on a retrospective basis. We adopted this guidance, as required, in the first quarter of 2016 and now present our deferred securities issuance costs as a reduction to the related liabilities on our consolidated balance sheets for all periods presented. At September 30, 2016 and December 31, 2015, we included zero and $0.5 million, respectively, of deferred securities issuance costs as a reduction to our ABS issued and presented these amounts together as ABS issued, net on our consolidated balance sheets and we included $8 million and $10 million, respectively, of deferred securities issuance costs as a reduction to our long-term debt and presented these amounts together as Long-term debt, net on our consolidated balance sheets.

In February 2015, the FASB issued ASU 2015-02, “Consolidation (Topic 810) - Amendments to the Consolidation Analysis.” This new guidance provides a new scope exception for certain money market funds, makes targeted amendments to the current consolidation guidance, and ends the deferral granted to investment companies from applying the VIE guidance. This new guidance is effective for annual periods beginning after December 15, 2015. We adopted this guidance, as required, in the first quarter of 2016, which did not have a material impact on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09,"Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." This new guidance is to simplify the accounting for share-based payment transactions, including related income tax accounting, classification of awards, and classification on the statement of cash flows. In addition, this guidance permits the withholding of employee taxes related to the distribution of equity awards up to the maximum individual employee statutory tax rates. This new guidance is effective for fiscal years beginning after December 15, 2016 and early adoption is permitted. In the second quarter of 2016, we adopted this new guidance. Upon adoption, we elected to account for forfeitures on employee equity awards as they occur, rather than estimating expected forfeitures. The adoption of this guidance did not have a material impact on our consolidated financial statements.

Other Recent Accounting Pronouncements

In October 2016, the FASB issued ASU 2016-17, "Consolidation (Topic 810): Interests Held Through Related Parties that Are Under Common Control." This new guidance amends the consolidation guidance on how a reporting entity, that is the single decision maker of a VIE, evaluates whether it is the primary beneficiary of a VIE. This new guidance is effective for fiscal years beginning after December 15, 2016. Early adoption is permitted. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have on our consolidated financial statements.

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. Early adoption is permitted. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have 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. Early adoption is permitted. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have on our consolidated financial statements.

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 year beginning December 15, 2018. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have on our consolidated financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2016
(Unaudited)

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

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. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have 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. We plan to adopt this new guidance by the required date and we are currently evaluating the impact that this update will have on our consolidated financial statements.

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. Early adoption is permitted in the first quarter of 2017. 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." This new ASU provides more specific guidance on certain aspects of Topic 606. Based on our initial evaluation of this new accounting standard, we do not expect that its adoption will have a material impact on our consolidated financial statements, as financial instruments are explicitly scoped out of the standard and nearly all of our income is generated from financial instruments. We will continue evaluating this new standard and caution that any changes in our business or additional amendments to this standard could change our initial assessment.

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.

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

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 September 30, 2016 and December 31, 2015.

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

September 30, 2016 (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)		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
Assets (2)						
Interest rate agreements	$29,073	$ —	$29,073	$(25,048)	$ (4,025)	$ —
TBAs	1,514	—	1,514	(1,467)	—	47
Futures	257	—	257	(54)	—	203
Total Assets	$30,844	$ —	$30,844	$(26,569)	$ (4,025)	$ 250
Liabilities (2)						
Interest rate agreements	$(95,171)	$ —	$(95,171)	$25,048	$ 70,123	$ —
TBAs	(4,335)	—	(4,335)	1,467	2,772	(96)
Futures	(54)	—	(54)	54	—	—
Loan warehouse debt	(837,846)	—	(837,846)	837,846	—	—
Security repurchase agreements	(279,559)	—	(279,559)	279,559	—	—
Total Liabilities	$(1,216,965)	$ —	$(1,216,965)	$1,143,974	$ 72,895	$ (96)

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

December 31, 2015 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet (1) Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets (2)						
Interest rate agreements	$7,781	$ —	$7,781	$(5,651)	$(1,917)	$213
Credit default index swaps	1,207	—	1,207	—	(720)	487
TBAs	2,734	—	2,734	(1,898)	(293)	543
Total Assets	$11,722	$ —	$11,722	$(7,549)	$(2,930)	$1,243
Liabilities (2)						
Interest rate agreements	$(58,366)	$ —	$(58,366)	$5,651	$52,715	$—
TBAs	(2,519)	—	(2,519)	1,898	7	(614)
Futures	(445)	—	(445)	—	445	—
Loan warehouse debt	(1,023,740)	—	(1,023,740)	1,023,740	—	—
Security repurchase agreements	(693,641)	—	(693,641)	693,641	—	—
Total Liabilities	$(1,778,711)	$ —	$(1,778,711)	$1,724,930	$53,167	$(614)

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

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

For each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions within that category between us and a counterparty are subject to a master netting arrangement or similar agreement with that counterparty that provides for individual transactions to be 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.

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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 September 30, 2016, we consolidated certain Sequoia securitization entities issued prior to 2012 that we determined were VIEs and for which we determined we were the primary beneficiary. As discussed in Note 2, we previously consolidated our Commercial Securitization through the second quarter of 2016 and our Residential Resecuritization through the fourth quarter of 2015. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

Table 4.1 – Assets and Liabilities of Consolidated VIEs

September 30, 2016 (Dollars in Thousands)	Sequoia Entities
Residential loans, held-for-investment	$839,976
Restricted cash	148
Accrued interest receivable	1,030
Other assets	6,245
Total Assets	$847,399
Accrued interest payable	$523
Asset-backed securities issued	819,868
Total Liabilities	$820,391
Number of VIEs	20

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Note 4. Principles of Consolidation - (continued)

December 31, 2015 (Dollars in Thousands)	Sequoia Entities	Commercial Securitization	Total
Residential loans, held-for-investment	$1,021,870	$ —	$1,021,870
Commercial loans, held-for-investment	—	166,016	166,016
Restricted cash	228	137	365
Accrued interest receivable	1,131	1,297	2,428
Other assets	4,895	—	4,895
Total Assets	$1,028,124	$ 167,450	$1,195,574
Accrued interest payable	$555	$ 249	$804
Accrued expenses and other liabilities	100	—	100
Asset-backed securities issued, net	996,820	53,137	1,049,957
Total Liabilities	$997,475	$ 53,386	$1,050,861
Number of VIEs	21	1	22

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 28 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes, in accordance with ASC 860. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSRs on our consolidated balance sheets, and classified those MSRs as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets. Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSRs (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.

The following table presents information related to securitization transactions that occurred during the three and nine months ended September 30, 2016 and 2015.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2016	2015	2016	2015
Principal balance of loans transferred	$348,537	$ —	$693,427	$1,038,451
Trading securities retained, at fair value	—	—	—	33,389
AFS securities retained, at fair value	1,839	—	3,673	6,309
MSRs recognized	1,971	—	4,102	7,874

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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 nine months ended September 30, 2016 and 2015 between us and the unconsolidated VIEs sponsored by us.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2016	2015	2016	2015
Proceeds from new transfers	$356,497	$ —	$708,539	$1,018,312
MSR fees received	3,473	3,817	10,397	11,287
Funding of compensating interest	(98)	(86)	(254)	(283)
Cash flows received on retained securities	6,384	8,190	24,314	31,541

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

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

	Three Months Ended September 30, 2016		Three Months Ended September 30, 2015		
At Date of Securitization	MSRs	Subordinate Securities	MSRs	Senior Securities	Subordinate Securities
Prepayment rate	24 %	15 %	N/A	N/A	N/A
Discount rates	11 %	7 %	N/A	N/A	N/A
Credit loss assumptions	N/A	0.25 %	N/A	N/A	N/A

	Nine Months Ended September 30, 2016		Nine Months Ended September 30, 2015		
At Date of Securitization	MSRs	Subordinate Securities	MSRs	Senior Securities	Subordinate Securities
Prepayment rate	22 %	15 %	14 %	8 %	8 %
Discount rates	11 %	7 %	11 %	3 %	6 %
Credit loss assumptions	N/A	0.25 %	N/A	0.25 %	0.25 %

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

The following table presents additional information at September 30, 2016 and December 31, 2015, related to unconsolidated VIEs sponsored by Redwood and accounted for as sales since 2012.

Table 4.5 – Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	September 30, 2016	December 31, 2015
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	$ 31,271	$ 258,697
Subordinate securities, classified as AFS	237,248	272,715
Mortgage servicing rights	35,609	56,984
Maximum loss exposure (1)	$ 304,128	$ 588,396
Assets transferred:		
Principal balance of loans outstanding	$ 6,990,350	$ 7,318,167
Principal balance of delinquent loans 30+ days delinquent	19,775	18,300

(1) 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, 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 September 30, 2016 and December 31, 2015.

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

September 30, 2016 (Dollars in Thousands)	MSRs	Senior Securities (1)	Subordinate Securities
Fair value at September 30, 2016	$35,609	$19,098	$249,421
Expected life (in years) (2)	5	5	12
Prepayment speed assumption (annual CPR) (2)	25 %	14 %	14 %
Decrease in fair value from:			
10% adverse change	$2,414	$893	$955
25% adverse change	5,687	2,119	2,364
Discount rate assumption (2)	11 %	15 %	5 %
Decrease in fair value from:			
100 basis point increase	$861	$551	$19,395
200 basis point increase	1,674	1,072	