REDWOOD TRUST INC
Form 10-Q
November 08, 2018

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, 2018

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 every Interactive Data File required to be submitted 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 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, 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	x	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	o

Emerging growth company o

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. 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 82,965,298 shares outstanding as of November 5, 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)	September 30, 2018	December 31, 2017
ASSETS [1]		
Residential loans, held-for-sale, at fair value	$ 866,444	$ 1,427,945
Residential loans, held-for-investment, at fair value	5,055,815	3,687,265
Business purpose loans, at fair value	115,620	—
Multifamily loans, held-for-investment, at fair value	942,165	—
Real estate securities, at fair value	1,470,084	1,476,510
Cash and cash equivalents	173,516	144,663
Restricted cash	27,253	2,144
Accrued interest receivable	35,644	27,013
Derivative assets	87,219	15,718
Other assets	365,875	258,564
Total Assets	$ 9,139,635	$ 7,039,822
LIABILITIES AND EQUITY [1]		
Liabilities		
Short-term debt [2]	$ 1,424,275	$ 1,938,682
Accrued interest payable	31,076	18,435
Derivative liabilities	42,724	63,081
Accrued expenses and other liabilities	102,278	67,729
Asset-backed securities issued, at fair value	3,406,985	1,164,585
Long-term debt, net	2,770,970	2,575,023
Total liabilities	7,778,308	5,827,535
Equity		
Common stock, par value $0.01 per share, 180,000,000 shares authorized; 82,930,281 and 76,599,972 issued and outstanding	829	766
Additional paid-in capital	1,785,957	1,673,845
Accumulated other comprehensive income	72,327	85,248
Cumulative earnings	1,410,854	1,290,341
Cumulative distributions to stockholders	(1,908,640)	(1,837,913)
Total equity	1,361,327	1,212,287
Total Liabilities and Equity	$ 9,139,635	$ 7,039,822

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(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, 2018 and December 31, 2017, assets of consolidated VIEs totaled $3,693,140 and $1,259,774, respectively. At September 30, 2018 and December 31, 2017, liabilities of consolidated VIEs totaled $3,417,835 and $1,167,157, respectively. See Note 4 for further discussion.

(2) At December 31, 2017, balance includes $250 million of convertible notes, which matured in April 2018. See Note 12 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)	Three Months Ended September 30,		Nine Months Ended September 30,	
(Unaudited)	2018	2017	2018	2017
Interest Income				
Residential loans	$63,265	$ 38,541	$169,010	$109,538
Business purpose loans	1,445	—	1,445	—
Multifamily loans	5,578	—	5,578	—
Real estate securities	27,063	23,425	79,054	65,068
Other interest income	2,046	771	3,905	1,983
Total interest income	99,397	62,737	258,992	176,589
Interest Expense				
Short-term debt	(14,146)	(10,182)	(40,756)	(23,985)
Asset-backed securities issued	(27,421)	(3,956)	(55,171)	(11,191)
Long-term debt	(22,784)	(13,305)	(58,151)	(37,532)
Total interest expense	(64,351)	(27,443)	(154,078)	(72,708)
Net Interest Income	35,046	35,294	104,914	103,881
Non-interest Income				
Mortgage banking activities, net	11,224	21,200	48,396	50,850
Investment fair value changes, net	10,332	324	12,830	9,990
Other income, net	3,453	2,812	8,893	9,473
Realized gains, net	7,275	1,734	21,352	8,809
Total non-interest income, net	32,284	26,070	91,471	79,122
Operating expenses	(21,490)	(19,922)	(63,529)	(56,789)
Net Income before Provision for Income Taxes	45,840	41,442	132,856	126,214
Provision for income taxes	(4,919)	(5,262)	(12,343)	(16,741)
Net Income	$40,921	$ 36,180	$120,513	$109,473
Basic earnings per common share	$0.49	$ 0.46	$1.51	$1.39
Diluted earnings per common share	$0.42	$ 0.41	$1.30	$1.26
Regular dividends declared per common share	$0.30	$ 0.28	$0.88	$0.84
Basic weighted average shares outstanding	80,796,856	76,850,830	77,211,188	76,803,324
Diluted weighted average shares outstanding	114,682,688	102,703,108	107,792,029	99,397,866

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

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

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
(Unaudited)	2018	2017	2018	2017
Net Income	$40,921	$36,180	$120,513	$109,473
Other comprehensive (loss) income:				
Net unrealized (loss) gain on available-for-sale securities	(2,408)	13,158	(9,749)	17,899
Reclassification of unrealized gain on available-for-sale securities to net income	(5,686)	(853)	(19,821)	(7,103)
Net unrealized gain (loss) on interest rate agreements	4,801	321	16,649	(375)
Reclassification of unrealized loss on interest rate agreements to net income	—	14	—	42
Total other comprehensive (loss) income	(3,293)	12,640	(12,921)	10,463
Total Comprehensive Income	$37,628	$48,820	$107,592	$119,936

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, 2018

(In Thousands, except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2017	76,599,972	$ 766	$ 1,673,845	$ 85,248	$ 1,290,341	$ (1,837,913)	$ 1,212,287
Net income	—	—	—	—	120,513	—	120,513
Other comprehensive loss	—	—	—	(12,921)	—	—	(12,921)
Issuance of common stock	7,187,500	72	116,964	—	—	—	117,036
Employee stock purchase and incentive plans	183,638	1	(101)	—	—	—	(100)
Non-cash equity award compensation	—	—	10,783	—	—	—	10,783
Share repurchases	(1,040,829)	(10)	(15,534)	—	—	—	(15,544)
Common dividends declared	—	—	—	—	—	(70,727)	(70,727)
September 30, 2018	82,930,281	$ 829	$ 1,785,957	$ 72,327	$ 1,410,854	$ (1,908,640)	$ 1,361,327

For the Nine Months Ended September 30, 2017

(In Thousands, except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2016	76,834,663	$ 768	$ 1,676,486	$ 71,853	$ 1,149,935	$ (1,749,614)	$ 1,149,428
Net income	—	—	—	—	109,473	—	109,473
Other comprehensive income	—	—	—	10,463	—	—	10,463
Employee stock purchase and incentive plans	288,024	3	(2,315)	—	—	—	(2,312)
Non-cash equity award compensation	—	—	7,797	—	—	—	7,797
Common dividends declared	—	—	—	—	—	(66,209)	(66,209)
September 30, 2017	77,122,687	$ 771	$ 1,681,968	$ 82,316	$ 1,259,408	$ (1,815,823)	$ 1,208,640

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, 2018	2017
Cash Flows From Operating Activities:		
Net income	$120,513	$109,473
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(11,091)	(14,246)
Depreciation and amortization of non-financial assets	922	909
Purchases of held-for-sale loans	(5,596,326)	(3,760,110)
Proceeds from sales of held-for-sale loans	4,097,211	3,079,877
Principal payments on held-for-sale loans	51,853	38,500
Net settlements of derivatives	36,721	(10,570)
Non-cash equity award compensation expense	10,783	7,797
Market valuation adjustments	(53,666)	(50,352)
Realized gains, net	(21,352)	(8,809)
Net change in:		
Accrued interest receivable and other assets	(32,722)	(19,868)
Accrued interest payable and accrued expenses and other liabilities	34,137	(1,677)
Net cash used in operating activities	(1,363,017)	(629,076)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(111,231)	—
Principal payments on loans held-for-investment	550,973	370,595
Purchases of real estate securities	(482,150)	(396,721)
Purchases of multifamily securities held in consolidated securitization trusts	(54,957)	—
Proceeds from sales of real estate securities	432,199	142,931
Principal payments on real estate securities	61,278	55,544
Sales (purchases) of mortgage servicing rights, net	6,344	50,705
Net investment in participation in loan warehouse facility	(37,814)	—
Other investing activities, net	(10,075)	—
Net cash provided by investing activities	354,567	223,054
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	4,760,083	3,126,949
Repayments on short-term debt	(5,274,664)	(2,968,050)
Proceeds from issuance of asset-backed securities	1,658,848	286,898
Repayments on asset-backed securities issued	(305,528)	(146,357)
Proceeds from issuance of long-term debt	199,000	245,000
Deferred long-term debt issuance costs paid	(4,977)	(7,380)
Net settlements of derivatives	(244)	(115)
Net proceeds from issuance of common stock	117,311	224
Net payments on repurchase of common stock	(16,315)	—
Taxes paid on equity award distributions	(375)	(2,536)
Dividends paid	(70,727)	(66,209)
Net cash provided by financing activities	1,062,412	468,424
Net increase in cash, cash equivalents and restricted cash	53,962	62,402
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]	$200,769	$283,869
Supplemental Cash Flow Information:		
Cash paid during the period for:		

Interest	$139,003	$67,339
Taxes	6,372	1,476
Supplemental Noncash Information:		
Real estate securities retained from loan securitizations	$46,872	$67,083
Retention of mortgage servicing rights from loan securitizations and sales	—	7,387
Consolidation of multifamily loans held in securitization trusts	946,650	—
Consolidation of multifamily ABS	880,602	—
Transfers from loans held-for-sale to loans held-for-investment	1,981,170	643,876
Transfers from loans held-for-investment to loans held-for-sale	15,717	98,853
Transfers from residential loans to real estate owned	2,139	3,177

(1) Cash, cash equivalents, and restricted cash at September 30, 2018 includes cash and cash equivalents of $174 million and restricted cash of $27 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
September 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 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 consolidate subsidiaries, unless the context otherwise requires.

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2018 and December 31, 2017, and for the three and nine months ended September 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 September 30, 2018 and results of operations for all periods presented have been made. The results of operations for the three and nine months ended September 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"). In addition, we consolidated the assets and liabilities of certain third-party Freddie Mac K-Series securitization trusts beginning in the third quarter of 2018. 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.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2018
(Unaudited)
Note 2. Basis of Presentation - (continued)

For financial reporting purposes, the underlying loans owned at the consolidated Sequoia entities are shown under Residential loans, held-for-investment, at fair value, and the underlying loans owned at the consolidated Freddie Mac K-Series are shown under Multifamily 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 13 for further discussion on ABS issued.
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 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 nine months ended September 30, 2018.

Business Purpose Loans at Fair Value

Business purpose loans include loans to investors in single-family rental properties ("Single-family rental loans") and loans to investors rehabilitating and reselling residential properties ("Fix-and-flip loans"). Our single-family rental loans are held-for-sale at fair value, as we have purchased these loans with the intent to sell to third parties or transfer to securitization entities. Fix-and-flip loans are primarily interest-only fixed-rate loans with a term of less than two years which are carried as held-for-investment at fair value.
Coupon interest for these loans is recognized as revenue when earned and deemed collectible or, for single-family rental loans, until a loan becomes more than 90 days past due, at which point the loan is placed on nonaccrual status. When a seriously delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Changes in fair value are recurring and reported through our consolidated statements of income in Mortgage banking activities, net and Investment fair value changes, net for single-family rental loans and fix-and-flip loans, respectively.

Multifamily Loans, Held-for-Investment at Fair Value

Multifamily loans are multifamily mortgage loans held in Freddie Mac-sponsored K-series securitization trusts that we consolidate. In accordance with accounting guidance for collateralized financing entities ("CFEs"), we use the fair value of the ABS issued by the Freddie Mac K-Series entities (which we determined to be more observable) to determine the fair value of the loans held at these entities. Coupon interest for these loans is recognized as revenue when earned and deemed collectible or, until a loan becomes more than 90 days past due, at which point the loan is placed on nonaccrual status. When a seriously delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Changes in fair value for the assets and liabilities of these trusts are recurring and are reported through our consolidated statements of income in Investment fair value changes, net.

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

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

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
September 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 August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement." This new guidance amends previous guidance by removing and modifying certain existing fair value disclosure requirements, while adding other new disclosure requirements. This new guidance is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted and entities may elect to early adopt the removal or modification of disclosures immediately and delay adoption of the new disclosure requirements until their effective date. 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 2018, the FASB issued ASU 2018-09, "Codification Improvements." This new guidance is intended to clarify, correct, and make minor improvements to the FASB Accounting Standards Codification. The transition and effective dates are based on the facts and circumstances of each amendment, with some amendments becoming effective upon issuance of this ASU and others becoming effective for annual periods beginning after December 15, 2018. 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 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.

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

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.

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 after 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 15, our only material leases are those related to our leased office space, for which future payments under these leases totaled $16 million at September 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.

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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 September 30, 2018 and December 31, 2017.

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

September 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]		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
Assets [2]						
Interest rate agreements	$78,006	$ —	$78,006	$(10,429)	$(28,159)	$39,418
TBAs	6,987	—	6,987	(919)	(5,234)	834
Futures	44	—	44	—	—	44
Total Assets	$85,037	$ —	$85,037	$(11,348)	$(33,393)	$40,296
Liabilities [2]						
Interest rate agreements	$(38,581)	$ —	$(38,581)	$10,429	$28,152	$—
TBAs	(1,744)	—	(1,744)	919	762	(63)
Loan warehouse debt	(578,157)	—	(578,157)	578,157	—	—
Security repurchase agreements	(780,818)	—	(780,818)	780,818	—	—
Total Liabilities	$(1,399,300)	$ —	$(1,399,300)	$1,370,323	$28,914	$(63)

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)

(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 balance 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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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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, 2018, we consolidated our Legacy Sequoia and Sequoia Choice securitization entities that we determined were VIEs and for which we determined we were the primary beneficiary. Additionally, in the third quarter of 2018 we consolidated certain third-party Freddie Mac K-Series 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 for the consolidated Sequoia entities 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 September 30, 2018, the estimated fair value of our investments in the consolidated Legacy Sequoia, Sequoia Choice, and Freddie Mac K-Series entities was $12 million, $196 million, and $67 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

September 30, 2018 (Dollars in Thousands)	Legacy Sequoia	Sequoia Choice	Freddie Mac K-Series	Total Consolidated VIEs
Residential loans, held-for-investment	$553,958	$2,181,195	$—	$2,735,153
Multifamily loans, held-for-investment	—	—	942,165	942,165
Restricted cash	147	11	—	158
Accrued interest receivable	860	9,046	2,843	12,749
REO	2,915	—	—	2,915
Total Assets	$557,880	$2,190,252	$945,008	$3,693,140
Accrued interest payable	$590	$7,643	$2,606	$10,839
Accrued expenses and other liabilities	—	11	—	11
Asset-backed securities issued	544,923	1,986,456	875,606	3,406,985
Total Liabilities	$545,513	$1,994,110	$878,212	$3,417,835
Number of VIEs	20	6	2	28

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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	Freddie Mac K-Series	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

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.

Beginning in the third quarter of 2018, we consolidated the assets and liabilities of two Freddie Mac K-Series securitization trusts as we invested in multifamily subordinate securities issued by these trusts and maintain certain discretionary rights associated with the ownership of these investments. We determined that our involvement with these VIEs reflected a controlling financial interest, and that we have both the power to direct the activities that most significantly impact the economic performance of the VIEs and the right to receive benefits of and the obligation to absorb losses from the VIE that could potentially be significant to the VIEs.

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 43 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 mortgage servicing rights ("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 servicing rights (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.

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Note 4. Principles of Consolidation - (continued)

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2018	2017	2018	2017
Principal balance of loans transferred	$327,511	$839,264	$2,735,644	$2,223,387
Trading securities retained, at fair value	2,583	24,617	48,831	55,607
AFS securities retained, at fair value	776	4,416	6,728	11,476
MSRs recognized	—	—	—	7,123

The following table summarizes the cash flows during the three and nine months ended September 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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2018	2017	2018	2017
Proceeds from new transfers	$329,231	$839,642	$2,723,012	$2,213,151
MSR fees received	3,405	3,631	10,216	10,804
Funding of compensating interest, net	(46)	(35)	(102)	(114)
Cash flows received on retained securities	7,267	6,882	21,720	19,843

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 nine months ended September 30, 2018 and 2017.

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

	Three Months Ended September 30, 2018			Three Months Ended September 30, 2017		
At Date of Securitization	MSRs	Senior IO Securities	Subordinate Securities	MSRs	Senior IO Securities	Subordinate Securities
Prepayment rates	N/A	9 %	9 %	N/A	11 %	10 %
Discount rates	N/A	14 %	7 %	N/A	14 %	5 %
Credit loss assumptions	N/A	0.20 %	0.20 %	N/A	0.25 %	0.25 %
	Nine Months Ended September 30, 2018			**Nine Months Ended September 30, 2017**		
At Date of Securitization	MSRs	Senior IO Securities	Subordinate Securities	MSRs	Senior IO Securities	Subordinate Securities
Prepayment rates	N/A	9 %	10 %	9 %	10 %	10 %
Discount rates	N/A	14 %	5 %	11 %	13 %	5 %
Credit loss assumptions	N/A	0.20 %	0.20 %	N/A	0.25 %	0.25 %

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Note 4. Principles of Consolidation - (continued)

The following table presents additional information at September 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)	September 30, 2018	December 31, 2017
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	$ 130,598	$ 101,426
Subordinate securities, classified as AFS	163,870	219,255
Mortgage servicing rights	62,325	60,980
Maximum loss exposure (1)	$ 356,793	$ 381,661
Assets transferred:		
Principal balance of loans outstanding	$ 10,349,405	$ 8,364,148
Principal balance of loans 30+ days delinquent	19,625	27,926

(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, 2018 and December 31, 2017.

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

September 30, 2018 (Dollars in Thousands)	MSRs	Senior Securities (1)	Subordinate Securities
Fair value at September 30, 2018	$62,325	$62,996	$231,472
Expected life (in years) (2)	9	8	15
Prepayment speed assumption (annual CPR) (2)	7 %	9 %	9 %
Decrease in fair value from:			
10% adverse change	$1,631	$2,156	$547
25% adverse change	3,974	5,145	1,361
Discount rate assumption (2)	11 %	11 %	6 %
Decrease in fair value from:			
100 basis point increase	$2,469	$2,383	$22,243
200 basis point increase	4,812	4,592	41,116
Credit loss assumption (2)	N/A	0.20 %	0.20 %
Decrease in fair value from:			
10% higher losses	N/A	$—	$559
25% higher losses	N/A	—	4,220

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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 $63 million and $34 million of interest-only securities at September 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 Unconsolidated 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 September 30, 2018, grouped by security type.

Table 4.7 – Third-Party Sponsored VIE Summary

(Dollars in Thousands)	September 30, 2018	December 31, 2017
Mortgage-Backed Securities		
Senior	$ 214,655	$ 216,066
Mezzanine	538,847	508,010
Subordinate	422,114	431,753
Total Investments in Third-Party Sponsored VIEs	$ 1,175,616	$ 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.

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 September 30, 2018 and December 31, 2017.

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

	September 30, 2018		December 31, 2017	
(In Thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	$866,331	$866,331	$1,427,052	$1,427,052
At lower of cost or fair value	113	133	893	993
Residential loans, held-for-investment				
At fair value	5,055,815	5,055,815	3,687,265	3,687,265
Business purpose loans	115,620	115,620	—	—
Multifamily loans	942,165	942,165	—	—
Trading securities	1,108,243	1,108,243	968,844	968,844
Available-for-sale securities	361,841	361,841	507,666	507,666
Cash and cash equivalents	173,516	173,516	144,663	144,663
Restricted cash	27,253	27,253	2,144	2,144
Accrued interest receivable	35,644	35,644	27,013	27,013
Derivative assets	87,219	87,219	15,718	15,718
MSRs (1)	63,785	63,785	63,598	63,598
REO (1)	2,915	3,490	3,354	3,806
Margin receivable (1)	48,655	48,655	85,044	85,044
FHLBC stock (1)	43,393	43,393	43,393	43,393
Guarantee asset (1)	2,885	2,885	2,869	2,869
Pledged collateral (1)	42,127	42,127	42,615	42,615
Participation in loan warehouse facility (1)	39,219	39,219	—	—
Liabilities				
Short-term debt	$1,424,275	$1,424,275	$1,688,412	$1,688,412
Accrued interest payable	31,076	31,076	18,435	18,435
Margin payable (2)	33,950	33,950	390	390
Guarantee obligation (2)	17,423	17,409	19,487	18,878
Derivative liabilities	42,724	42,724	63,081	63,081
ABS issued at fair value, net	3,406,985	3,406,985	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	632,401	639,684	686,759	692,369
Trust preferred securities and subordinated notes, net	138,570	108,113	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 nine months ended September 30, 2018, we elected the fair value option for $32 million and $105 million of residential senior securities, $128 million and $417 million of subordinate securities, and $1.79 billion and $5.52 billion of residential loans (principal balance), respectively. Additionally, during the three months ended September 30, 2018, we elected the fair value option for $126 million of business purpose loans (principal balance) and $963 million of multifamily loans (principal balance). 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 business purpose loans and for certain securities we purchase, including IO securities and fixed-rate securities rated investment grade or higher.

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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 September 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

September 30, 2018	Carrying Value	Fair Value Measurements Using		
(In Thousands)		Level 1	Level 2	Level 3
Assets				
Residential loans	$5,922,146	$—	$—	$5,922,146
Business purpose loans	115,620	—	—	115,620
Multifamily loans	942,165	—	—	942,165
Trading securities	1,108,243	—	—	1,108,243
Available-for-sale securities	361,841	—	—	361,841
Derivative assets	87,219	7,031	78,006	2,182
MSRs	63,785	—	—	63,785
Pledged collateral	42,127	42,127	—	—
FHLBC stock	43,393	—	43,393	—
Guarantee asset	2,885	—	—	2,885
Liabilities				
Derivative liabilities	$42,724	$1,744	$38,581	$2,399
ABS issued	3,406,985	—	—	3,406,985

December 31, 2017	Carrying Value	Fair Value Measurements Using		
(In Thousands)		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

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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 nine months ended September 30, 2018.

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

	Assets								Liabilities
(In Thousands)	Residential Loans	Business Purpose Loans	Multifamily 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	5,570,683	126,214	946,650	522,293	6,728	—	—	—	2,539,451
Sales	(4,135,911)	—	—	(348,054)	(118,423)	(1,077)	—	—	—
Principal paydowns	(587,162)	(10,912)	(286)	(25,847)	(35,431)	—	—	—	(305,529)
Gains (losses) in net income, net	(37,641)	318	(4,199)	2,098	32,494	1,264	16	(8,093)	8,478
Unrealized losses in OCI, net	—	—	—	—	(31,193)	—	—	—	—
Other settlements, net [2]	(2,140)	—	—	(11,091)	—	—	—	6,162	—
Ending Balance - September 30, 2018	$5,922,146	$115,620	$942,165	$1,108,243	$361,841	$63,785	$2,885	$(217)	$3,406,985

(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.

(2) Other settlements, net for residential loans represents the transfer of loans to REO, and for derivatives, the 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. Other settlements, net for our trading securities relates to the consolidation of the Freddie Mac K-Series entities during the three months ended September 30, 2018.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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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 September 30, 2018 and 2017. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and nine months ended September 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 September 30, 2018 and 2017 Included in Net Income

	Included in Net Income			
	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2018	2017	2018	2017
Assets				
Residential loans at Redwood	$(18,100)	$14,359	$(70,316)	$24,227
Residential loans at consolidated Sequoia entities	(8,978)	3,497	11,936	22,949
Business purpose loans	(20)	—	(20)	—
Multifamily loans at consolidated Freddie Mac K-Series entities	(4,199)	—	(4,199)	—
Trading securities	3,821	(36)	(1,956)	24,452
Available-for-sale securities	(33)	(3)	(90)	(248)
MSRs	337	317	4,861	(1,005)
Loan purchase commitments	2,168	2,117	2,157	2,121
Other assets - Guarantee asset	(51)	(239)	15	(1,043)
Liabilities				
Loan purchase commitments	$(2,314)	$—	$(2,388)	$—
ABS issued	12,536	(7,771)	(8,478)	(30,286)

The following table presents information on assets recorded at fair value on a non-recurring basis at September 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 September 30, 2018.

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

September 30, 2018	Carrying Value	Fair Value Measurements Using			Gain (Loss) for	
					Three Months Ended	Nine Months Ended
(In Thousands)		Level 1	Level 2	Level 3	September 30, 2018	September 30, 2018
Assets						
REO	$ 1,804	$ —	$ —	$ 1,804	$(37)	$ (162)

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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 nine months ended September 30, 2018 and 2017.

Table 5.6 – Market Valuation Gains and Losses, Net

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2018	2017	2018	2017
Mortgage Banking Activities, Net				
Residential loans held-for-sale, at fair value	$5,626	$14,859	$16,522	$29,175
Single-family rental loans held-for-sale, at fair value	(121)	—	(121)	—
Residential loan purchase and forward sale commitments	1,610	13,276	(8,116)	33,947
Risk management derivatives, net	3,796	(7,077)	38,378	(13,787)
Total mortgage banking activities, net (1)	$10,911	$21,058	$46,663	$49,335
Investment Fair Value Changes, Net				
Residential loans held-for-investment, at Redwood	$(17,063)	$2,881	$(71,058)	$8,902
Fix-and-flip loans held-for-investment	53	—	53	—
Trading securities	6,314	607	2,429	30,676
Valuation adjustments on commercial loans held-for-sale	—	—	—	300
Net investments in Legacy Sequoia entities (2)	(248)	(1,045)	(976)	(3,842)
Net investments in Sequoia Choice entities (2)	(943)	(256)	43	(256)
Net investments in Freddie Mac K-Series entities (2)	511	—	511	—
Risk-sharing investments	(126)	(267)	(474)	(985)
Risk management derivatives, net	21,867	(1,592)	82,391	(24,557)
Impairments on AFS securities	(33)	(4)	(89)	(248)
Total investment fair value changes, net	$10,332	$324	$12,830	$9,990
Other Income, Net				
MSRs	$(823)	$(1,351)	$1,324	$(10,842)
MSR risk management derivatives, net	(890)	(422)	(7,151)	1,869
Total other income, net (3)	$(1,713)	$(1,773)	$(5,827)	$(8,973)
Total Market Valuation Gains, Net	$19,530	$19,609	$53,666	$50,352

(1) Mortgage banking activities, net presented above does not include fee income or provisions for repurchases that are 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.

At September 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.

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

Table 5.7 – Fair Value Methodology for Level 3 Financial Instruments

September 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	$2,729,424	Whole loan spread to TBA price	$1.84	-$2.80		$2.77	
		Whole loan spread to swap rate	90	-198	bps	193	bps
Jumbo hybrid loans	319,029	Prepayment rate (annual CPR)	15	-15	%	15	%
		Whole loan spread to swap rate	75	-155	bps	125	bps
Jumbo loans committed to sell	138,540	Whole loan committed sales price	$100.98	-$101.15		$101.08	
Loans held by Legacy Sequoia (1)	553,958	Liability price		N/A		N/A	
Loans held by Sequoia Choice (1)	2,181,195	Liability price		N/A		N/A	
Business purpose loans:							
Single-family rental loans	20,105	Whole loan spread to swap rate	247	-247	bps	247	bps
		Prepayment rate (annual CPR)	3	-3	%	3	%
Fix-and-flip loans	95,515	Discount rate	7	-8	%	7	%
Multifamily loans held by Freddie Mac K-Series (1)	942,165	Liability price		N/A		N/A	
Trading and AFS securities	1,470,084	Discount rate	3	-15	%	6	%
		Prepayment rate (annual CPR)	—	-50	%	8	%
		Default rate	—	-27	%	2	%
		Loss severity	—	-40	%	22	%
MSRs	63,785	Discount rate	11	-67	%	11	%
		Prepayment rate (annual CPR)	4	-22	%	7	%
		Per loan annual cost to service	$82	-$82		$82	
Guarantee asset	2,885	Discount rate	11	-11	%	11	%
		Prepayment rate (annual CPR)	7	-7	%	7	%

REO	1,804	Loss severity	13	-45	%	30	%
Liabilities							
ABS issued [1]:							
At consolidated Sequoia entities	2,531,379	Discount rate	3	-15	%	4	%
		Prepayment rate (annual CPR)	8	-32	%	19	%
		Default rate	—	-8	%	2	%
		Loss severity	20	-20	%	20	%
At consolidated Freddie Mac K-Series entities	875,606	Discount rate	3	9	%	4	%
		Prepayment rate (annual CPR)	—	—	%	—	%
		Default rate	1	1	%	1	%
		Loss severity	20	20	%	20	%
Loan purchase commitments, net	217	MSR multiple	1.0	-5.4	x	3.5	x
		Pull-through rate	16	-100	%	72	%
		Whole loan spread to TBA price	$2.69	-$2.69		$2.69	
		Whole loan spread to swap rate - fixed rate	90	-198	bps	196	bps
		Prepayment rate (annual CPR)	15	-15	%	15	%
		Whole loan spread to swap rate - hybrid	75	-155	bps	99	bps

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

Footnote to Table 5.7

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

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 and multifamily loans at consolidated entities

We have elected to account for the consolidated securitization entities as 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 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 CFEs.

Business purpose loans

Business purpose loans include fix-and-flip loans and single-family rental loans 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.

Prices for our single-family rental loans are determined using market comparable information. Significant inputs obtained from market activity include indicative spreads to indexed swap rates (Level 3) for fixed-rate loans and assumed future prepayment rates. These assets would generally decrease in value based upon an increase in the credit spread or prepayment speed assumptions.

Prices for our fix-and-flip loans are determined using discounted cash flow modeling, which incorporates a primary significant unobservable input of discount rate. Other inputs include assumed future prepayment rates and anticipated credit losses. These assets would generally decrease in value based upon an increase in the discount rate.

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

Real estate securities

Real estate securities include residential, multifamily, and other mortgage-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 September 30, 2018, we received dealer price indications on 79% of our securities, representing 86% 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.

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).

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

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).

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).

Real Estate Owned

Real Estate Owned ("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).

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

ABS issued
ABS issued includes asset-backed securities issued through the Legacy Sequoia and Sequoia Choice securitization entities, as well as securities issued by certain third-party Freddie Mac K-series securitization entities which we consolidate. 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).
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).

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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 September 30, 2018 and December 31, 2017.
Table 6.1 – Classifications and Carrying Values of Residential Loans

September 30, 2018		Legacy	Sequoia	
(In Thousands)	Redwood	Sequoia	Choice	Total
Held-for-sale				
At fair value	$866,331	$—	$—	$866,331
At lower of cost or fair value	113	—	—	113
Total held-for-sale	866,444	—	—	866,444
Held-for-investment at fair value	2,320,662	553,958	2,181,195	5,055,815
Total Residential Loans	$3,187,106	$553,958	$2,181,195	$5,922,259

December 31, 2017		Legacy	Sequoia	
(In Thousands)	Redwood	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 September 30, 2018, we owned mortgage servicing rights associated with $2.53 billion (principal balance) of consolidated residential loans purchased from third-party originators. The value of these MSRs is included in the carrying value of the associated loans on our consolidated balance sheets. We contract with licensed sub-servicers that perform servicing functions for these loans.
Residential Loans Held-for-Sale
At Fair Value
At September 30, 2018, we owned 1,232 loans held-for-sale at fair value with an aggregate unpaid principal balance of $859 million and a fair value of $866 million, 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 September 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 nine months ended September 30, 2018, we purchased $1.79 billion and $5.52 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold $1.90 billion and $5.83 billion (principal balance) of loans, respectively, for which we recorded net market valuation gains of $6 million and $16 million, respectively, through Mortgage banking activities, net on our consolidated statements of income. At September 30, 2018, loans held-for-sale with a market value of $622 million were pledged as collateral under short-term borrowing agreements.
During the three and nine months ended September 30, 2017, we purchased $1.43 billion and $3.72 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold $1.05 billion and $3.08 billion (principal balance) of loans, respectively, for which we recorded net market valuation gains of $15 million and $29 million, respectively, through Mortgage banking activities, net on our consolidated statements of income.

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Note 6. Residential Loans - (continued)

At Lower of Cost or Fair Value
At September 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 September 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 September 30, 2018, we owned 3,259 held-for-investment loans at Redwood with an aggregate unpaid principal balance of $2.36 billion and a fair value of $2.32 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 September 30, 2018, two 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 nine months ended September 30, 2018, we transferred loans with a fair value of $116 million and $204 million, respectively, from held-for-sale to held-for-investment. During the three and nine months ended September 30, 2018, we transferred loans with a fair value of $16 million from held-for-investment to held-for-sale. During the three and nine months ended September 30, 2018, we recorded net market valuation losses of $17 million and $71 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net on our consolidated statements of income. At September 30, 2018, loans with a fair value of $2.27 billion were pledged as collateral under a borrowing agreement with the FHLBC.
During the three and nine months ended September 30, 2017, we transferred loans with a fair value of $78 million and $326 million, respectively, from held-for-sale to held-for-investment. During both the three and nine months ended September 30, 2017, we transferred loans with a fair value of $98 million from held-for-investment to held-for-sale. During the three and nine months ended September 30, 2017, we recorded net market valuation gains of $3 million and $9 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net on our consolidated statements of income.
At September 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 Fair Isaac Corporation ("FICO") score of borrowers backing these loans was 769 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 66% (at origination). At September 30, 2018, these loans were comprised of 87% 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 4.20%.
At Consolidated Legacy Sequoia Entities
At September 30, 2018, we consolidated 2,777 held-for-investment loans at consolidated Legacy Sequoia entities, with an aggregate unpaid principal balance of $581 million and a fair value of $554 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 September 30, 2018 and December 31, 2017, the unpaid principal balance of loans at consolidated Legacy Sequoia entities delinquent greater than 90 days was $16 million and $25 million, respectively, of which the unpaid principal balance of loans in foreclosure was $8 million and $10 million, respectively. During the three and nine months ended September 30, 2018, we recorded net market valuation gains of $4 million and $37 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income. During the three and nine

months ended September 30, 2017, we recorded net market valuation gains of $4 million and $24 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.

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Note 6. Residential Loans - (continued)

At Consolidated Sequoia Choice Entities
At September 30, 2018, we consolidated 2,928 held-for-investment loans at the consolidated Sequoia Choice entities, with an aggregate unpaid balance of $2.16 billion and a fair value of $2.18 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 744, the weighted average LTV ratio of these loans was 75%, and the loans were all first lien and prime-quality. At September 30, 2018, one of these loans with an unpaid principal balance of $1 million was 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 nine months ended September 30, 2018, we transferred loans with a fair value of $796 million and $1.78 billion, respectively, from held-for-sale to held-for-investment associated with Choice securitizations. During the three and nine months ended September 30, 2018, we recorded net market valuation losses of $13 million and $25 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 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. Business Purpose Loans
Our business purpose loans include single-family rental loans and fix-and-flip loans. At September 30, 2018, all of our outstanding business purpose loans were acquired from a related party, 5 Arches LLC ("5 Arches"). See Note 11 for information on our equity investment in 5 Arches. The following table summarizes the classifications and carrying values of the business purpose loans owned at Redwood at September 30, 2018 and December 31, 2017.
Table 7.1 – Classifications and Carrying Values of Business Purpose Loans

(In Thousands)	September 30, 2018	December 31, 2017
Single-family rental loans, held-for-sale at fair value	$ 20,105	$ —
Fix-and-flip loans, held-for-investment at fair value	95,515	—
Total Business Purpose Loans	$ 115,620	$ —

Single-Family Rental Loans Held-for-Sale at Fair Value
Under an agreement with 5 Arches, we have exclusive access to their single-family rental loan production through April 2019. At September 30, 2018, we owned four single-family rental loans purchased under this agreement with an aggregate unpaid principal balance of $20 million and a fair value of $20 million. At September 30, 2018, none of these loans were greater than 90 days delinquent or in foreclosure. During both the three and nine months ended September 30, 2018, we purchased $20 million (principal balance) of loans, for which we elected the fair value option, and we did not sell any loans. During both the three and nine months ended September 30, 2018, we recorded a net market valuation loss of $0.1 million on single-family rental loans held-for-sale at fair value through Mortgage banking activities, net on our consolidated statements of income. At September 30, 2018, loans held-for-sale with a market value of $20 million were pledged as collateral under short-term borrowing agreements.
The outstanding single-family rental loans held-for-sale at September 30, 2018 were first lien, fixed-rate loans with maturities of five, seven, or ten years. At September 30, 2018, the weighted average coupon of our single-family rental loans was 5.71% and the weighted average loan term was seven years. At origination, the weighted average LTV ratio of these loans was 65% and the weighted average debt service coverage ratio ("DSCR") was 1.25.

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Note 7. Business Purpose Loans - (continued)

Fix-and-Flip Loans Held-for-Investment at Fair Value

At September 30, 2018, we owned 128 fix-and-flip loans held-for-investment with an aggregate unpaid principal balance of $95 million and a fair value of $96 million. At September 30, 2018, two of these loans with an aggregate unpaid principal balance of $1 million were greater than 90 days delinquent and none of these loans were in foreclosure. During both the three and nine months ended September 30, 2018, we purchased $106 million (principal balance) of loans, and we did not sell any loans. During both the three and nine months ended September 30, 2018, we recorded a net market valuation gain of less than $0.1 million on fix-and-flip loans held-for-investment at fair value through Investment fair value changes, net on our consolidated statements of income. At September 30, 2018, loans with a market value of $92 million were pledged as collateral under short-term borrowing agreements.

The outstanding fix-and-flip loans held-for-investment at September 30, 2018 were first lien, fixed-rate, interest-only loans with a weighted average coupon of 9.14% and original maturities of 6 to 24 months. At origination, the weighted average FICO score of borrowers backing these loans was 718, the weighted average LTV ratio of these loans was 76%, and the estimated rehabilitated LTV ratio was 57%.

Note 8. Multifamily Loans

During the third quarter of 2018, we invested in multifamily subordinate securities issued by two Freddie Mac K-Series securitization trusts and were required to consolidate the underlying multifamily loans owned at these entities for financial reporting purposes in accordance with GAAP. At September 30, 2018, we consolidated 80 held-for-investment multifamily loans, with an aggregate unpaid balance of $963 million and a fair value of $942 million. We did not own or consolidate any multifamily loans at December 31, 2017. The outstanding multifamily loans held-for-investment at the Freddie Mac K-Series entities at September 30, 2018 were first lien, fixed-rate loans that were originated in 2015 and 2016 and had original loan terms of seven to ten years and an original weighted average LTV ratio of 69%. At September 30, 2018, the weighted average coupon of these multifamily loans was 4.15% and the weighted average loan term was seven years. At September 30, 2018, none of these loans were greater than 90 days delinquent or in foreclosure.

During both the three and nine months ended September 30, 2018, we recorded a net market valuation loss of $4 million 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 ABS issued associated with the securitizations. The net impact to our income statement associated with our economic investment in the securities of the Freddie Mac K-Series securitization entities is presented in Note 5.

Note 9. 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 September 30, 2018 and December 31, 2017.

Table 9.1 – Fair Values of Real Estate Securities by Type

(In Thousands)	September 30, 2018	December 31, 2017
Trading	$ 1,108,243	$ 968,844
Available-for-sale	361,841	507,666
Total Real Estate Securities	$ 1,470,084	$ 1,476,510

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. Most of 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.

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Note 9. Real Estate Securities - (continued)

Trading Securities
The following table presents the fair value of trading securities by position and collateral type at September 30, 2018 and December 31, 2017.
Table 9.2 – Trading Securities by Position and Collateral Type

(In Thousands)	September 30, 2018	December 31, 2017
Senior	$ 163,022	$ 69,974
Mezzanine	602,235	563,475
Subordinate	342,986	335,395
Total Trading Securities	$ 1,108,243	$ 968,844

We elected the fair value option for certain securities and classify them as trading securities. Our trading securities include both residential and multifamily securities. At September 30, 2018, trading securities with a carrying value of $668 million as well as $129 million of securities retained from our consolidated Sequoia Choice securitizations were pledged as collateral under short-term borrowing agreements. See Note 12 for additional information on short-term debt.
At September 30, 2018 and December 31, 2017, our senior trading securities included $86 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 $79 million and zero, respectively. Our interest-only securities included $42 million and $15 million of A-IO-S securities at September 30, 2018 and December 31, 2017, respectively, which are securities we retained from certain of our Sequoia securitizations that represent certificated servicing strips.
At September 30, 2018 and December 31, 2017, our mezzanine and subordinate trading securities had an unpaid principal balance of $1.07 billion and $943 million, respectively. At September 30, 2018 and December 31, 2017, the fair value of our mezzanine and subordinate securities was $945 million and $899 million, respectively, and included $236 million and $301 million, respectively, of Agency residential mortgage credit risk transfer (or "CRT") securities, $68 million and $68 million, respectively, of Sequoia securities, $225 million and $206 million, respectively, of other third-party residential securities, and $417 million and $324 million, respectively, of third-party multifamily securities.
During the three and nine months ended September 30, 2018, we acquired $189 million and $567 million (principal balance), respectively, of securities for which we elected the fair value option and classified as trading, and sold $79 million and $323 million, respectively, of such securities. During the three and nine months ended September 30, 2017, we acquired $171 million and $432 million (principal balance), respectively, of securities for which we elected the fair value option and classified as trading, and sold $25 million and $85 million, respectively, of such securities.
During the three and nine months ended September 30, 2018, we recorded net market valuation gains of $6 million and $2 million, respectively, on trading securities, included in Investment fair value changes, net on our consolidated statements of income. During the three and nine months ended September 30, 2017, we recorded net market valuation gains of $1 million and $31 million, respectively, on trading securities, included in Investment fair value changes, net on our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 9. 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 September 30, 2018 and December 31, 2017.
Table 9.3 – Available-for-Sale Securities by Position and Collateral Type

(In Thousands)	September 30, 2018	December 31, 2017
Senior	$ 114,628	$ 179,864
Mezzanine	36,377	92,002
Subordinate	210,836	235,800
Total AFS Securities	$ 361,841	$ 507,666

At September 30, 2018 and December 31, 2017, all of our available-for-sale securities were comprised of residential mortgage-backed securities. At September 30, 2018, AFS securities with a carrying value of $121 million were pledged as collateral under short-term borrowing agreements. See Note 12 for additional information on short-term debt.
During the three and nine months ended September 30, 2018, we purchased $1 million and $7 million of AFS securities, respectively, and sold $26 million and $118 million of AFS securities, respectively, which resulted in net realized gains of $7 million and $21 million, respectively. During the three and nine months ended September 30, 2017, we purchased $4 million and $32 million of AFS securities, respectively, and sold $23 million and $61 million of AFS securities, respectively, which resulted in net realized gains of $2 million and $9 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 September 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 September 30, 2018 and December 31, 2017.
Table 9.4 – Carrying Value of AFS Securities
September 30, 2018

(In Thousands)	Senior	Mezzanine	Subordinate	Total
Principal balance	$119,254	$37,385	$308,445	$465,084
Credit reserve	(7,919)	—	(33,155)	(41,074)
Unamortized discount, net	(25,173)	(3,843)	(131,783)	(160,799)
Amortized cost	86,162	33,542	143,507	263,211
Gross unrealized gains	29,134	2,835	67,896	99,865
Gross unrealized losses	(668)	—	(567)	(1,235)
Carrying Value	$114,628	$36,377	$210,836	$361,841

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Note 9. 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 nine months ended September 30, 2018, in unamortized discount and designated credit reserves on residential AFS securities.

Table 9.5 – Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
(In Thousands)	Credit Reserve	Unamortized Discount, Net	Credit Reserve	Unamortized Discount, Net
Beginning balance	$42,191	$ 170,090	$46,549	$ 183,753
Amortization of net discount	—	(3,323)	—	(11,231)
Realized credit losses	(616)	—	(1,957)	—
Acquisitions	637	224	5,424	2,354
Sales, calls, other	(777)	(6,586)	(1,843)	(21,265)
Impairments	33	—	89	—
(Release of) transfers to credit reserves, net	(394)	394	(7,188)	7,188
Ending Balance	$41,074	$ 160,799	$41,074	$ 160,799

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 September 30, 2018 and December 31, 2017.

Table 9.6 – Components of Fair Value of Residential AFS Securities by Holding Periods

	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
(In Thousands)	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
September 30, 2018	$14,791	$ (567)	$14,224	$23,901	$ (668)	$23,233
December 31, 2017	8,637	(132)	8,505	28,557	(1,235)	27,322

At September 30, 2018, after giving effect to purchases, sales, and extinguishment due to credit losses, our consolidated balance sheet included 139 AFS securities, of which 11 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.

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Note 9. Real Estate Securities - (continued)

Evaluating AFS Securities for Other-than-Temporary Impairments

Gross unrealized losses on our AFS securities were $1 million at September 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 September 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 months ended September 30, 2018, other-than-temporary impairments were $0.4 million, of which less than $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 nine months ended September 30, 2018, other-than-temporary impairments were $0.6 million, of which $0.1 million were recognized through our consolidated statements of income and $0.5 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 September 30, 2018.

Table 9.7 – Significant Valuation Assumptions

September 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 September 30, 2018 and 2017, for which a portion of an OTTI was recognized in other comprehensive income.

Table 9.8 – Activity of the Credit Component of Other-than-Temporary Impairments

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	2018	2017	2018	2017
Balance at beginning of period	$20,967	$25,802	$21,037	$28,261
Additions				
Initial credit impairments	33	—	76	178

Subsequent credit impairments	—	—	—	47
Reductions				
Securities sold, or expected to sell	(927)	—	(1,026)	(2,282)
Securities with no outstanding principal at period end	(1,229)	(42)	(1,243)	(444)
Balance at End of Period				