NovaBay Pharmaceuticals, Inc.
Form 10-Q
May 02, 2013

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

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 001-33678

NOVABAY PHARMACEUTICALS, INC.
(Exact name of registrant as specified in its charter)

Delaware	68-0454536
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

5980 Horton Street, Suite 550, Emeryville CA 94608
(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (510) 899-8800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	x

(Do not check if a smaller reporting company)

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

As of April 29, 2013, there were 37,330,837 shares of the registrant's common stock outstanding.

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NOVABAY PHARMACEUTICALS, INC.

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Unless the context requires otherwise, all references in this report to "we," "our," "us," the "Company" and "NovaBay" refer to NovaBay Pharmaceuticals, Inc. and its subsidiaries.

NovaBay®, NovaBay Pharma®, AgaNase®, Aganocide®, NeutroPhase®, AgaDerm®, and Going Beyond AntibioticsTM are trademarks of NovaBay Pharmaceuticals, Inc. All other trademarks and trade names are the property of their respective owners.

PART I
FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)	March 31, 2013 (unaudited)	December 31, 2012 (Note 2)
ASSETS		
Current assets:		
Cash and cash equivalents	$8,387	$12,735
Short-term investments	4,805	4,135
Accounts receivable	916	943
Inventory	61	23
Prepaid expenses and other current assets	365	445
Total current assets	14,534	18,281
Property and equipment, net	819	891
Other assets	63	63
TOTAL ASSETS	$15,416	$19,235
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	$539	$455
Accrued liabilities	1,178	1,497
Deferred revenue	757	1,221
Total current liabilities	2,474	3,173
Deferred revenues - non-current	730	671
Deferred rent	73	60
Warrant liability	1,802	1,282
Total liabilities	5,079	5,186
Stockholders' equity:		
Preferred stock, $0.01 par value; 5,000 shares authorized; none outstanding at at March 31, 2013 and December 31, 2012	—	—
Common stock, $0.01 par value; 65,000 shares authorized at March 31, 2013 and December 31, 2012; 37,241 and 36,915 issued and outstanding at March 31, 2013 and December 31, 2012, respectively	369	369
Additional paid-in capital	54,299	54,004
Accumulated other comprehensive loss	(11)	(13)
Accumulated deficit during development stage	(44,320)	(40,311)
Total stockholders' equity	10,337	14,049
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$15,416	$19,235

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

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NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(unaudited)

(in thousands, except per share data)	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012	Cumulative Period from July 1, 2002 (inception) to March 31, 2013
Sales:			
Sales revenue	$63	$—	$63
Cost of goods sold	22	—	22
Gross profit	41	—	41
Other revenue:			
License, collaboration and distribution revenue	$914	$1,315	$58,368
Other revenues	43	5	161
Total other revenue	957	1,320	58,529
Operating expenses:			
Research and development	2,925	2,264	63,071
General and administrative	1,560	1,541	41,195
Total operating expenses	4,485	3,805	104,266
Operating loss	(3,487)	(2,485)	(45,696)
Non-cash gain (loss) on (increase) decrease in fair value of warrants	(520)	(35)	187
Other income (expense), net	—	(5)	1,266
Loss before income taxes	(4,007)	(2,525)	(44,243)
Provision for income taxes	(2)	(6)	(77)
Net loss	(4,009)	(2,531)	(44,320)
Change in unrealized gains (losses) on available-for-sale securities	2	2	(11)
Comprehensive loss	$(4,007)	$(2,529)	$(44,331)
Net loss per share:			
Basic and diluted	$(0.11)	$(0.09)	
Shares used in per share calculations:			
Basic and diluted	36,756	28,572	

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

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NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

(in thousands)	Three Months Ended March 31, 2013	2012	Cumulative Period from July 1, 2002 (inception) to March 31, 2013
Cash flows from operating activities:			
Net loss	$(4,009)	$(2,531)	$(44,320)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	81	91	2,351
Accretion of discount on short-term investments	—	—	(252)
Net realized loss on sales of short-term investments	9	12	125
Loss on disposal of property and equipment	—	30	313
Stock-based compensation expense for options and stock issued to employees and directors	215	342	6,256
Compensation expense for warrants issued for services	3	20	203
Stock-based compensation expense for options, warrants and stock issued to non-employees	47	127	1,289
Non-cash loss (gain) on increase (decrease) in fair value of warrants	520	35	(187)
Taxes paid by LLC	—	—	1
Changes in operating assets and liabilities:			
(Increase) decrease in accounts receivable	27	(1,006)	(916)
Purchase of inventory	(38)	—	(61)
(Increase) decrease in prepaid expenses and other assets	80	24	(616)
Increase (decrease) in accounts payable and accrued liabilities	(222)	167	1,996
Increase (decrease) in deferred revenue	(405)	(47)	1,836
Net cash used in operating activities	(3,692)	(2,736)	(31,982)
Cash flows from investing activities:			
Purchases of property and equipment	(9)	—	(3,370)
Proceeds from disposal of property and equipment	—	1	52
Purchases of short-term investments	(2,127)	(712)	(115,545)
Proceeds from maturities and sales of short-term investments	1,450	1,175	110,799
Cash acquired in purchase of LLC	—	—	516
Net cash provided by (used in) investing activities	(686)	464	(7,548)
Cash flows from financing activities:			
Proceeds from preferred stock issuances, net	—	—	11,160
Proceeds from common stock issuances	15	—	3,207
Proceeds from exercise of options and warrants	15	36	2,121
Proceeds from initial public offering, net of costs	—	—	17,077
Proceeds from shelf offering, net of costs	—	—	13,231

Proceeds from stock subscription receivable	—	—	873
Proceeds from issuance of notes	—	—	405
Principal payments on capital lease	—	—	(157)
Proceeds from short-term borrowing	—	—	88
Principal payment on short-term borrowing	—	(71)	(88)
Proceeds from borrowings under equipment loan	—	—	1,216
Principal payments on equipment loan	—	—	(1,216)
Net cash provided by (used in) financing activities	30	(35)	47,917
Net increase (decrease) in cash and cash equivalents	(4,348)	(2,307)	8,387
Cash and cash equivalents, beginning of period	12,735	8,428	—
Cash and cash equivalents, end of period	$8,387	$6,121	$8,387

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

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1. ORGANIZATION

NovaBay Pharmaceuticals is a clinical-stage biotechnology company focused on addressing the large unmet therapeutic needs of the global anti-infective market with its two distinct categories of products.

Aganocide® Compounds
NovaBay's first-in-class Aganocide® compounds, led by auriclosene (NVC-422), are patented, synthetic molecules with a broad spectrum of activity against bacteria, viruses and fungi. Mimicking the mechanism of action that human white blood cells use against infections, Aganocides possess a reduced likelihood that bacteria or viruses will be able to develop resistance, which is critical for advanced anti-infectives. Having demonstrated therapeutic proof-of-concept in three Phase 2 clinical studies, these compounds are well suited to treat and prevent a wide range of local, non-systemic infections. NovaBay is currently focused in three large therapeutic markets:

- Dermatology - Partnered with Galderma, a leading dermatology company, the companies are developing a gel formulation of auriclosene (NVC-422) for treating the highly contagious skin infection, impetigo. A global Phase 2b clinical study is currently underway with results expected to be available in the second half of 2013.

- Ophthalmology - NovaBay is developing an eye drop formulation of auriclosene (NVC-422) for treating adenoviral conjunctivitis, for which there is currently no FDA-approved treatment. The company expects to complete a global Phase 2b clinical study for this indication in the last half of 2013.

- Urology – NovaBay's urinary catheter irrigation solution containing auriclosene (NVC-422) is currently in Phase 2 clinical studies, with the goal of reducing the incidence of urinary catheter blockage and encrustation (UCBE) and the associated urinary tract infections. The company reported positive data from Part A of this study and expects to announce interim top-line results from Part B of this study mid-year

NeutroPhase®
NovaBay is also developing another class of molecule, NeutroPhase®, which is an FDA 510(k)-cleared product for advanced wound care. With a distinct mechanism of action from Aganocides, we believe that NeutroPhase is the only patented pure hypochlorous acid solution available and has the potential to be best suited to treat the six-million-patients in the U.S. who suffer from chronic non-healing wounds, such as pressure, venous stasis and diabetic ulcers.

NovaBay has begun securing commercial partnerships for NeutroPhase. In January 2012, NovaBay announced it had entered into a strategic marketing agreement with Pioneer Pharma Co., Ltd., a Shanghai-based company that markets high-end pharmaceutical products into China, to market NeutroPhase in China. In September 2012, the collaboration with Pioneer Pharma was expanded to include the Asian markets Hong Kong, Macau, Taiwan, Singapore, Malaysia, Indonesia, Myanmar, Philippines, Thailand, Vietnam, Brunei, Cambodia and Laos. NovaBay expects to announce additional marketing agreements in select geographic markets around the world during 2013.

The Company was incorporated under the laws of the State of California on January 19, 2000, as NovaCal Pharmaceuticals, Inc. The Company had no operations until July 1, 2002, on which date it acquired all of the operating assets of NovaCal Pharmaceuticals, LLC, a California limited liability company. In February 2007, the

Company changed its name from NovaCal Pharmaceuticals, Inc. to NovaBay Pharmaceuticals, Inc. In August 2007, it formed two subsidiaries—NovaBay Pharmaceuticals Canada, Inc., a wholly-owned subsidiary incorporated under the laws of British Columbia (Canada), which was formed to conduct research and development in Canada but was dissolved in July 2012, and DermaBay, Inc., a wholly-owned U.S. subsidiary, which may explore and pursue dermatological opportunities. In June 2010, the Company changed the state in which it is incorporated (the Reincorporation), and is now incorporated under the laws of the State of Delaware. All references to "we," "us," "our," or "the Company" herein refer to the California corporation prior to the date of the Reincorporation, and to the Delaware corporation on and after the date of the Reincorporation. The Company currently operate in four business segments; see Note 10 for further details.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements of NovaBay Pharmaceuticals, Inc. have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") for interim reporting including the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. These statements do not include all disclosures for annual audited financial statements required by accounting principles generally accepted in the United States of America ("U.S. GAAP") and should be read in conjunction with the Company's audited consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. The consolidated balance sheet at December 31, 2012, has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company believes these consolidated financial statements reflect all adjustments (consisting only of normal, recurring adjustments) that are necessary for a fair presentation of the financial position and results of operations for the periods presented. Results of operations for the interim periods presented are not necessarily indicative of results to be expected for the year.

The financial statements have been prepared under the guidelines for Development Stage Entities. A development stage enterprise is one in which planned principal operations have not commenced, or if its operations have commenced, there have been no significant revenues therefrom. As of March 31, 2013, we continued to conduct clinical trials and had not commenced our planned principal operations.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, NovaBay Pharmaceuticals Canada, Inc. (prior to its dissolution in July 2012) and DermaBay, Inc. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include useful lives for property and equipment and related depreciation calculations, estimated amortization period for payments received from product development and license agreements as they relate to revenue recognition, assumptions for valuing options and warrants, and income taxes. Actual results could differ from those estimates.

Cash, Cash Equivalents and Short-Term Investments

The Company considers all highly liquid instruments with a stated maturity of three months or less at the date of purchase to be cash and cash equivalents. Cash and cash equivalents are stated at cost, which approximates their fair value. As of March 31, 2013, the Company’s cash and cash equivalents were held in financial institutions in the United States and include deposits in money market funds, which were unrestricted as to withdrawal or use.

The Company classifies all highly liquid investments with a stated maturity of greater than three months at the date of purchase as short-term investments. Short-term investments generally consist of municipal and corporate debt securities. The Company has classified its short-term investments as available-for-sale. The Company does not intend to hold securities with stated maturities greater than twelve months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income (loss) until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis. A decline in the market value below cost of any available-for-sale security that is determined to be other-than-temporary results in a revaluation of its carrying amount to fair value and an impairment charge to earnings, resulting in a new cost basis for the security. No such impairment charges were recorded for the periods presented. The interest income and realized gains and losses are included in other income (expense), net within the consolidated statements of operations and comprehensive loss. Interest income is recognized when earned.

Concentrations of Credit Risk and Major Partners

Financial instruments which potentially subject us to significant concentrations of credit risk consist primarily of cash and cash equivalents and short-term investments. The Company maintains deposits of cash, cash equivalents and short-term investments with three highly-rated, major financial institutions in the United States.

Deposits in these banks may exceed the amount of federal insurance provided on such deposits. The Company does not believe it is exposed to significant credit risk due to the financial position of the financial institutions in which these deposits are held. Additionally, the Company has established guidelines regarding diversification and investment maturities, which are designed to maintain safety and liquidity.

During the three months ended March 31, 2013, revenues were derived from two collaboration partners, two distribution partners and service revenues. During the three months ended March 31, 2012, the majority of the Company’s operating revenues were derived from one collaborative partner.

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of March 31, 2013, 94% of accounts receivable was derived from one collaboration and one distribution partner. As of March 31, 2012, the majority of the Company's accounts receivable was from one collaborative partner.

Comprehensive Income (Loss)

ASC 220, Comprehensive Income requires that an entity's change in equity or net assets during a period from transactions and other events from non-owner sources be reported. The Company reports unrealized gains and losses on its available-for-sale securities as other comprehensive income (loss).

Fair Value of Financial Assets and Liabilities

Financial instruments, including cash and cash equivalents and short-term investments, accounts payable and accrued liabilities are carried at cost, which management believes approximates fair value due to the short-term nature of these instruments. The fair value of capital lease obligations and equipment loans approximates their carrying amounts because the obligations bear market rates of interest.

The Company measures the fair value of financial assets and liabilities based on U.S. GAAP guidance which defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements.

Under U.S. GAAP, fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy is also established, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1 – quoted prices in active markets for identical assets or liabilities;
Level 2 – quoted prices for similar assets and liabilities in active markets or inputs that are observable;
Level 3 – inputs that are unobservable (for example cash flow modeling inputs based on assumptions).

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the related assets of five to seven years for office and laboratory equipment, three years for software and seven years for furniture and fixtures. Leasehold improvements are depreciated over the shorter of seven years or the lease term. Depreciation of assets recorded under capital leases is included in depreciation expense.

The costs of normal maintenance, repairs, and minor replacements are charged to operations when incurred.

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with U.S. GAAP, which requires that companies consider whether events or changes in facts and circumstances, both internally and externally, may indicate that an impairment of long-lived assets held for use are present. Management periodically evaluates the carrying value of long-lived assets and has determined that there was no impairment as of all periods presented. Determination of recoverability is based on the estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. In the event that such cash flows are not expected to be sufficient to recover the carrying amount of the asset, the assets are written down to their estimated fair values and the loss is recognized in the statements of operations.

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Revenue Recognition

License and collaboration revenue is primarily generated through agreements with strategic partners for the development and commercialization of the Company's product candidates. The terms of the agreements typically include non-refundable upfront fees, funding of research and development activities, payments based upon achievement of certain milestones and royalties on net product sales. In accordance with revenue recognition criteria under U.S. GAAP, the Company analyzes its multiple element arrangements to determine whether the elements can be separated. The Company performs its analysis at the inception of the arrangement and as each product or service is delivered. If a product or service is not separable, the combined deliverables are accounted for as a single unit of accounting and revenue is recognized over the performance obligation period. Revenue is recognized when the following criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred and risk of loss has passed; the seller's price to the buyer is fixed or determinable; and collectability is reasonably assured.

Assuming the elements meet the revenue recognition guidelines the revenue recognition methodology prescribed for each unit of accounting is summarized below:

Upfront Fees—The Company defers recognition of non-refundable upfront fees if it has continuing performance obligations without which the technology licensed has no utility to the licensee. If it has performance obligations through research and development services that are required because its know-how and expertise related to the technology is proprietary to it, or can only be performed by it, then such up-front fees are deferred and recognized over the period of the performance obligations. The Company bases the estimate of the period of performance on factors in the contract. Actual time frames could vary and could result in material changes to its results of operations.

Funded Research and Development— Revenue from research and development services is recognized during the period in which the services are performed and is based upon the number of full-time-equivalent personnel working on the specific project at the agreed-upon rate. This revenue approximates the cost incurred. Reimbursements from collaborative partners for agreed-upon direct costs including direct materials and outsourced, or subcontracted, pre-clinical studies are classified as revenue and recognized in the period the reimbursable expenses are incurred. Payments received in advance are recorded as deferred revenue until the research and development services are performed or costs are incurred.

Milestones—Substantive milestone payments are considered to be performance bonuses that are recognized upon achievement of the milestone only if all of the following conditions are met: the milestone payments are non-refundable; achievement of the milestone involves a degree of risk and was not reasonably assured at the inception of the arrangement; substantive effort is involved in achieving the milestone; the amount of the milestone is reasonable in relation to the effort expended or the risk associated with achievement of the milestone; and a reasonable amount of time passes between the up-front license payment and the first milestone payment as well as between each subsequent milestone payment. If any of these conditions are not met, the milestone payments are deferred and recognized as revenue over the term of the arrangement as we complete our performance obligations.

Royalties—The Company recognizes royalty revenues from licensed products upon the sale of the related products.

Research and Development Costs

The Company charges research and development costs to expense as incurred. These costs include salaries and benefits for research and development personnel, costs associated with clinical trials managed by contract research organizations, and other costs associated with research, development and regulatory activities. The Company uses external service providers to conduct clinical trials, to manufacture supplies of product candidates and to provide various other research and development-related products and services. Research and development expenses under the collaborative agreements approximate the revenue recognized, excluding milestone and upfront payments received under such arrangements.

Patent Costs

Patent costs, including legal expenses, are expensed in the period in which they are incurred. Patent expenses are included in general and administrative expenses in the consolidated statements of operations and comprehensive loss.

Stock-Based Compensation

The Company accounts for stock-based compensation under the provisions of ASC 718, Compensation-Stock Compensation. Under the fair value recognition provisions, stock-based compensation expense is measured at the grant date for all stock-based awards to employees and directors and is recognized as expense over the requisite service period, which is generally the vesting period. Non-employee stock-based compensation charges are amortized over the vesting period on a straight-line basis. For stock options granted, the fair value of the stock options is estimated using a Black-Scholes-Merton option pricing model.   See Note 8 for further information regarding stock-based compensation expense and the assumptions used in estimating that expense.

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Income Taxes

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized if it is more likely than not that some portion or the entire deferred tax asset will not be recognized.

Common Stock Warrant Liabilities

For warrants where there is a deemed possibility that the Company may have to settle the warrants in cash, the Company records the fair value of the issued warrants as a liability at each balance sheet date and records changes in the estimated fair value as a non-cash gain or loss in the consolidated statement of operations and comprehensive loss. The fair values of these warrants have been determined using the Binomial Lattice (“Lattice”) valuation model. The Lattice model provides for assumptions regarding volatility, call and put features and risk-free interest rates within the total period to maturity. These values are subject to a significant degree of judgment on the part of the Company.

Net Income (Loss) per Share

The Company computes net income (loss) per share by presenting both basic and diluted earnings (loss) per share (EPS).

Basic EPS is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period including stock options and warrants, using the treasury stock method, using the if-converted method. In computing diluted EPS, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options or warrants. Potentially dilutive common share equivalents are excluded from the diluted EPS computation in net loss periods since their effect would be anti-dilutive. During the three months ended March 31, 2013, and 2012, there is no difference between basic and diluted net loss per share due to the Company’s net losses. The following table sets forth the calculation of basic EPS and diluted EPS:

	Three Months Ended March 31,	
(in thousands, except per share amounts)	2013	2012
Net loss	$(4,009)	$(2,531)
Basic shares	36,756	28,572
	—	—

Add: shares issued upon assumed exercise of stock options		
Diluted shares	36,756	28,572
Basic and diluted net loss per share	$(0.11)	$(0.09)

The following outstanding stock options and stock warrants were excluded from the diluted net loss per share computation as their effect would have been anti-dilutive:

	Three Months Ended March 31,	
(In thousands)	2013	2012
Stock options	6,683	5,958
Stock warrants	11,210	4,923
	17,893	10,881

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Recent Accounting Pronouncements

There have been no recent accounting pronouncements or changes in accounting pronouncements during the three months ended March 31, 2013, as compared to the recent accounting pronouncements described in the Company's Form 10-K for the year ended December 31, 2012, that are of significance or potential significance to the Company.

NOTE 3. INVESTMENTS

Short-term investments at March 31, 2013, and December 31, 2012 consisted of the following:

	March 31, 2013			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Corporate bonds	$ 482	$ —	$ (3)	$ 479
Municipal bonds	305	—	(4)	301
Certificates of deposit	$ 4,029	$ —	$ (4)	$ 4,025
	$ 4,816	$ —	$ (11)	$ 4,805

	December 31, 2012			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Corporate bonds	$ 514	$ —	$ (9)	$ 505
Municipal bonds	$ 305	—	(2)	303
Certificates of deposit	3,329	—	(2)	3,327
	$ 4,148	$ —	$ (13)	$ 4,135

All short-term investments at March 31, 2013 and December 31, 2012 mature in less than one year. Unrealized holding gains and losses classified as available-for-sale are recorded in accumulated other comprehensive loss.

The Company recognized realized losses of $9,000 and $12,000, for the three months ended March 31, 2013 and 2012, respectively.

NOTE 4. FAIR VALUE MEASUREMENTS

The Company's cash equivalents and investments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices in active markets, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The types of investments that are generally classified within Level 1 of the fair value hierarchy include money market securities. The types of investments that are generally classified within Level 2 of the fair value hierarchy include corporate securities and certificates of deposits.

The Company's warrant liabilities are classified within level 3 of the fair value hierarchy because the value is calculated using significant judgment based on our own assumptions in the valuation of these liabilities.

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis as of March 31, 2013:

		Fair Value Measurements Using		
(in thousands)	Balance at March 31, 2013	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Cash equivalents	$ 8,387	$ 8,387	$ —	$ —
Short-term investments:				
Corporate bonds	479	—	479	—
Municipal bonds	301	—	301	
Certificates of deposit	4,025	—	4,025	—
Total short-term investments	4,805	—	4,805	—
Total assets	$ 13,192	$ 8,387	$ 4,805	$ —
Liabilities				
Warrant liability	$ 1,802	$ —	$ —	$ 1,802
Total liabilities	$ 1,802	$ —	$ —	$ 1,802

For the three month period ended March 31, 2013, as a result of the fair value adjustment of the warrant liability, the Company recorded a non-cash loss on an increase in the fair value of $520,000 in its consolidated statement of operations and comprehensive loss. See Note 6 for further discussion on the calculation of the fair value of the warrant liability.

(in thousands)	Warrant liability
Fair value of warrants at December 31, 2012	$1,282
Adjustment to fair value at March 31, 2013	520
Total warrant liability at March 31, 2013	$1,802

NOTE 5. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases laboratory facilities and office space under an operating lease which will expire on October 31, 2020. Rent expense was approximately $219,000 and $259,000 for the three months ended March 31, 2013 and 2012, respectively.

The Company's monthly rent payments fluctuate under the master lease agreement. In accordance with U.S. GAAP, the Company recognizes rent expense on a straight-line basis. The Company records deferred rent for the difference between the amounts paid and recorded as expense.

Directors and Officers Indemnity

As permitted under Delaware law and in accordance with its bylaws, the Company shall indemnify its officers and directors for certain events or occurrences while the officer or director is or was serving at its request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential future indemnification is unlimited; however, the Company has a director or officer insurance policy that limits its exposure and may enable them to recover a portion of any future payments. The Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liability has been recorded for these agreements as of March 31, 2013.

In the normal course of business, the Company provides indemnifications of varying scope under agreements with other companies, typically its clinical research organizations, investigators, clinical sites, suppliers and others. Pursuant to these agreements, the Company generally indemnifies, holds harmless, and agrees to reimburse the indemnified parties for losses suffered or incurred by the indemnified parties in connection with use or testing of its products or product candidates or with any U.S. patent or any copyright or other intellectual property infringement claims by any third party with respect to their products. The term of these indemnification agreements is generally perpetual. The potential future payments the Company could be required to make under these indemnification agreements is unlimited. Historically, costs related to these indemnification provisions have been immaterial. The Company also maintains various liability insurance policies that limit its exposure. As a result, the Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liabilities have been recorded for these agreements as of March 31, 2013.

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Legal Matters

From time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. There are no matters at March 31, 2013, that, in the opinion of management, would have a material adverse effect on the Company's financial position, results of operations or cash flows.

NOTE 6. WARRANT LIABILITY

In July 2011, the Company sold common stock and warrants in a registered direct financing. As part of this transaction, 3,488,005 warrants were issued with an exercise price of $1.33 and were exercisable on January 1, 2012, and expire on July 5, 2016. The terms of the warrants require registered shares to be delivered upon each warrant's exercise and also require possible cash payments to the warrant holders (in lieu of the warrant's exercise) upon specified fundamental transactions involving the Company's common stock, such as in an acquisition of the Company. Under ASC 480, "Distinguishing Liabilities from Equity" ("ASC 480"), the Company's ability to deliver registered shares upon an exercise of the warrants and the Company's potential obligation to cash-settle the warrants if specified fundamental transactions occur are deemed to be beyond the Company's control. The warrants contain a provision where the warrant holder would have the option to receive cash, equal to the Black Scholes fair value of the remaining unexercised portion of the warrant, as cash settlement in the event that there is a fundamental transaction (contractually defined to include various merger, acquisition or stock transfer activities). Due to this provision, ASC 480 requires that these warrants be classified as liabilities. The fair values of these warrants have been determined using the Binomial Lattice ("Lattice") valuation model, and the changes in the fair value are recorded in the consolidated statement of operations and comprehensive loss. The Lattice model provides for assumptions regarding volatility and risk-free interest rates within the total period to maturity. In addition, after January 5, 2012, and if the closing bid price per share of the common stock on the principal market equals or exceeds $2.66 for any ten trading days (which do not need to be consecutive) in a period of fifteen consecutive trading days, the Company has the right to require the exercise of one-third of the warrants then held by the warrant holders, which would result in gross proceeds to the Company of approximately $1.5 million.

The key assumptions used to value the warrants were as follows:

	March 31,			
Assumption	2013		2012	
Expected price volatility	55	%	80	%
Expected term (in years)	3.26		4.26	
Risk-free interest rate	0.41	%	0.84	%
Dividend yield	0.00	%	0.00	%
Weighted-average fair value of warrants	$0.52		$0.79	

NOTE 7. STOCKHOLDERS' EQUITY

On July 5, 2011, the Company closed a registered direct offering for the sale of 4,650,675 units (The "July 2011 Registered Direct Financing"), each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.75 of a share of common stock (or a total of 3,488,005 shares), at a purchase price of $1.11 per unit. The warrants will be exercisable 180 days after issuance for $1.33 per share and will expire five years from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together in the July 2011 Registered Direct Offering. The Company raised a total of $5.2 million from the July 2011 Registered Direct Financing, or approximately $4.6 million in net proceeds after deducting underwriting commissions of $288,000 and other offering costs of $244,000.

On December 6, 2012, the Company closed a public offering for the sale of 5,900,000 units, each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.75 of a share of common stock (or a total of 4,425,000 shares), at a purchase price of $1.25 per unit. The warrants were immediately exercisable for $1.50 per share and will expire one year from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together. The Company raised a total of $7.4 million from this offering, or approximately $6.6 million in net proceeds after deducting underwriting commissions of $479,000 and other offering costs of $240,000.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock Warrants

At March 31, 2013, there were outstanding warrants to purchase 1,225,000 shares of common stock with an exercise price of $2.75 per share expiring on August 21, 2014. These outstanding warrants were exercisable at March 31, 2012.

In July 2011, 3,488,005 warrants were issued in connection with our July 2011 Registered Direct Financing. These warrants were issued with an exercise price of $1.33 and expire on July 5, 2016. These outstanding warrants were exercisable at March 31, 2012. During 2012, 22,500 of these warrants were exercised and the Company received $30,000 in cash for the warrants.

In January 2012, warrants to purchase 60,000 shares were issued to a vendor. These warrants were issued with an exercise price of $2.50 per share for 30,000 of the shares and $3.75 per share for the remaining 30,000 shares and became exercisable monthly through June 30, 2012, and expire on January 2, 2016. The warrants were valued at approximately $34,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 75% and 89%, respectively, (2) a risk-free interest rate of 0.30% and 0.36% respectively and (3) an expected life of 2.36 and 2.98 years, respectively. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized $0 and $20,000 in expense during the three months ended March 31, 2013, and 2012, respectively, related to these warrants.

In September 2012 and October 2012, warrants to purchase 800,000 and 1,200,000 shares, respectively, were issued to Pioneer Pharma Co., Ltd as part of a unit purchase agreement that was accounted for along with an expanded distribution agreement. These warrants were issued with an exercise price of $1.50 per share, are immediately exercisable, and expire on August 31, 2013. The warrants were valued at approximately $360,000 and $330,000, respectively, using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 79% and 71%, respectively, (2) a risk-free interest rate of 0.17% and 0.17%, respectively and (3) an expected life of 0.96 and 0.83 years, respectively. Due to the combined accounting of this agreement along with the expanded distribution agreement, the Company accounted for the fair value of the common stock and warrants as equity.

In October 2012, warrants to purchase 15,000 shares were issued to a vendor. These warrants were issued with an exercise price of $2.50 per share and 5,000 shares became exercisable on each of October 30, 2012, November 30, 2012, and December 30, 2012, and they all expire on September 30, 2014. The warrants were valued at approximately $4,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 72%, (2) a risk-free interest rate of 0.27% and (3) an expected life of 2.00 years. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized $0 in expense during the three months ended March 31, 2013, and 2012, related to these warrants.

On December 6, 2012, 4,425,000 warrants were issued in connection with our July public offering. These warrants were issued with an exercise price of $1.50 and expire on December 6, 2013. These outstanding warrants were exercisable at March 31, 2013.

In January 2013, warrants to purchase 20,000 shares were issued to a vendor. These warrants were issued with an exercise price of $1.50 per share for 10,000 of the shares and $1.75 per share for the remaining 10,000 shares, became exercisable immediately, and expire on August 31, 2013, and December 31, 2013, respectively. The warrants were valued at approximately $3,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 69.82% and 69.40%, respectively, (2) a risk-free interest rate of 0.11% and 0.14%, respectively and (3) an expected life of 0.64 and 0.97 years, respectively. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized $3,000 and $0 in expense during the three months ended March 31, 2013, and 2012, respectively, related to these warrants.

NOVABAY PHARMACEUTICALS, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The details of all outstanding warrants as of March 31, 2013, is as follows:

(in thousands, except per share data)	Warrants	Weighted-Average Exercise Price
Outstanding at December 31, 2012	11,190	$ 1.59
Warrants issued	20	$ 1.63
Outstanding at March 31, 2013	11,210	$ 1.59

NOTE 8. EQUITY-BASED COMPENSATION

Equity Compensation Plans

Prior to our Initial Public Offering (IPO), the Company had two equity plans in place: the 2002 Stock Option Plan and the 2005 Stock Option Plan. Upon the closing of the IPO in October 2007, the Company adopted the 2007 Omnibus Incentive Plan (the "2007 Plan") to provide for the granting of stock awards, such as stock options, unrestricted and restricted common stock, stock units, dividend equivalent rights, and stock appreciation rights to employees, directors and outside consultants as determined by the board of directors. In conjunction with the adoption of the 2007 Plan, no further option awards may be granted from the 2002 or 2005 Stock Option Plans and any option cancellations or expirations from the 2002 or 2005 Stock Option Plans may not be reissued. As of March 31, 2013, there were 836,821 shares available for future grant under the 2007 Plan.

Under the terms of the 2007 Plan, the exercise price of incentive stock options may not be less than 100% of the fair market value of the common stock on the date of grant and, if granted to an owner of more than 10% of the Company's stock, then not less than 110%. Stock options granted under the 2007 Plan expire no later than ten years from the date of grant. Stock options granted to employees generally vest over four years while options granted to directors and consultants typically vest over a shorter period, subject to continued service. All of the options granted prior to October 2007 include early exercise provisions that allow for full exercise of the option prior to the option vesting, subject to certain repurchase provisions. The Company issues new shares to satisfy option exercises under the plans.

Stock Option Summary

The following table summarizes information about the Company's stock options outstanding at March 31, 2013, and activity during the three-month period then ended:

(in thousands, except years and per share data)	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2012	6,222	$ 1.62		
Options granted	772	$ 1.16		
Options exercised	(14)	$ 1.09		
Restricted stock unit vested	(173)	$ —		
Options forfeited/cancelled	(124)	$ 1.51		

Outstanding at March 31, 2013	6,683	$	1.61	6.85	$	1,104
Vested and expected to vest at March 31, 2013	6,499	$	1.63	6.80	$	1,044
Vested at March 31, 2013	4,727	$	1.78	6.00	$	573
Exercisable at March 31, 2013	4,727	$	1.78	6.00	$	573

Stock Options and Awards to Employees and Directors

The Company grants options to purchase common stock to its employees and directors at prices equal to or greater than the market value of the stock on the dates the options are granted. The Company has estimated the value of stock option awards as of the date of the grant by applying the Black-Scholes-Merton option pricing model using the single-option valuation approach. The application of this valuation model involves assumptions that are judgmental and subjective in nature. See Note 2 for a description of the accounting policies that the Company applied to value its stock-based awards.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The weighted-average assumptions used in determining the value of options granted and a summary of the methodology applied to develop each assumption are as follows:

Assumption	Three Months Ended March 31, 2013		2012	
Expected price volatility	87	%	94	%
Expected term (in years)	4.95		4.32	
Risk-free interest rate	0.80	%	0.72	%
Dividend yield	0.00	%	0.00	%
Weighted-average fair value of options granted during the period	$0.78		$0.93	

For the three months ended March 31, 2013 and 2012, the Company recognized stock-based compensation expense of $215,000 and $342,000, respectively, for option awards to employees and directors. As of March 31, 2013, total unrecognized compensation cost related to unvested stock options was $1.3 million. This amount is expected to be recognized as stock-based compensation expense in the Company’s consolidated statements of operations and comprehensive loss over the remaining weighted average vesting period of 2.58 years.

Stock-Based Awards to Non-Employees

During the three months ended March 31, 2013 and 2012, the Company granted options to purchase an aggregate of 62,000 and 55,000 shares of common stock, respectively, to non-employees in exchange for advisory and consulting services. Additionally, during the three months ended March 31, 2013 and 2012, the Company issued 11,856 and 60,527 shares of common stock, respectively, to non-employees. The stock options are recorded at their fair value on the measurement date and recognized over the respective service or vesting period. The fair value of the stock options granted was calculated using the Black-Scholes-Merton option pricing model based upon the following assumptions:

Assumption	Three Months Ended March 31, 2013		2012	
Expected price volatility	77	%	88	%
Expected term (in years)	8.88		8.79	
Risk-free interest rate	1.65	%	1.82	%
Dividend yield	0.00	%	0.00	%
Weighted-average fair value of options granted during the period	$0.98		$1.17	

For the three months ended March 31, 2013 and 2012, the Company recognized stock-based compensation expense of $47,000 and $127,000, respectively, related to non-employee stock and option grants.

Summary of Stock-Based Compensation Expense

Stock-based compensation expense is classified in the consolidated statements of operations and comprehensive loss in the same expense line items as cash compensation. Since the Company continues to operate at a net loss, it does not expect to realize any current tax benefits related to stock options.

A summary of the stock-based compensation expense included in the consolidated statement of operations and comprehensive loss for the options and stock discussed above is as follows:

	Three Months Ended March 31,	
(in thousands)	2013	2012
Research and development	$179	$125
General and administrative	86	364
Total stock-based compensation expense	$265	$489

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 9. LICENSE, COLLABORATION AND DISTRIBUTION AGREEMENTS

Galderma

On March 25, 2009, the Company entered into a collaboration and license agreement with Galderma S.A. to develop and commercialize the Company's Aganocide compounds, which covers acne and impetigo and potentially other major dermatological conditions, excluding onychomycosis (nail fungus), orphan drug indications and most post surgical use and use in wound care. The Company amended this agreement in December 2009 and again in December 2010. Based on the Impetigo Phase 2a clinical trial results, in December 2010, NovaBay and Galderma S.A., agreed to expand their partnership to focus on the development of NovaBay's Aganocide compound auriclosene (NVC-422) for the topical treatment of impetigo. This expansion is intended to provide NovaBay with the additional funding and resources required for the clinical development of its auriclosene (NVC-422) topical gel formulation for impetigo and other topical infections.

This agreement is exclusive and worldwide in scope, with the exception of Asian markets and North America, as described in the next paragraph.

Galderma is responsible for the development costs of product candidate compounds, except for costs incurred in Japan. In Japan, Galderma has the option to request that the Company share such development costs. Under the original agreement, the Company was supporting the ongoing development program for impetigo; however under the second amendment, entered into on December 2, 2010, Galderma has exercised its option and increased its support to cover the cost of development for this indication. Upon the achievement of a specified milestone, Galderma will reimburse NovaBay for specified, previously incurred expenses related to the development of the impetigo program. NovaBay retains the right to co-market products resulting from the agreement in Japan. In addition, NovaBay has retained all rights to co-promote the products developed under the agreement in hospitals and other healthcare institutions in North America.

Galderma will pay to NovaBay certain upfront fees, ongoing fees, reimbursements, and milestone payments related to achieving development and commercialization of its Aganocide compounds. If products are commercialized under the agreement, NovaBay's royalties will escalate as sales increase. The Company received a $1.0 million upfront technology access fee payment in the first quarter of 2009 and a $3.25 million continuation fee and a $500,000 fee to expand the license to include the Asia-Pacific Territory in December 2010. These fees were recorded as deferred revenues and recognized as earned on a straight-line basis over the Company's expected performance period. The initial upfront technology access fee was recognized over the initial 20 month funding term of the agreement through October 2010, and the continuation and license fees are being recognized over the additional three year funding term of the agreement through November 2013.

Revenue has been recognized under the Galderma agreement as follows:

	Three Months Ended March 31,	
(in thousands)	2013	2012
Amortization of Upfront Technology Access Fee	$315	$315
On-going Research and Development (FTE)	409	401
Materials, Equipment, and Contract Study Costs	11	589

Total	$735	$1,305

The Company had deferred revenue balances of $631,000 and $957,000 at March 31, 2013 and December 31, 2012, respectively, related to the Galderma agreement, which consisted of the unamortized balances on the upfront technology and access fee and the continuation and license fee and support for ongoing research and development. As of March 31, 2013, the Company has earned $4.25 million in milestone payments. As of March 31, 2013, the Company has not earned or received any royalty payments under the Galderma agreement.

Pioneer Pharma Co., Ltd.

In January 2012, the Company entered into a distribution agreement with Pioneer Pharma Co., Ltd., a Shanghai-based company that markets high-end pharmaceutical products into China, for the commercialization of NeutroPhase in this territory. Under the terms of the agreement, NovaBay received an upfront payment of $312,500. NovaBay also received $312,500 in January 2013, related to the submission of the first marketing approval for the product to the CFDA (formerly the SFDA, State Food and Drug Administration), which was submitted in December 2012. The distribution agreement provides that Pioneer Pharma Co., Ltd is entitled to receive cumulative purchase discounts of up to $500,000 upon the purchase of NeutroPhase product. The deferred revenue will be recognized as the purchase discounts are earned, with the remaining deferred revenue recognized ratable over the product distribution period. In addition, NovaBay is entitled to receive $625,000 upon receipt of an MAA approval of the product from the CFDA.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In September 2012, we entered into two agreements with Pioneer Pharma Co., Ltd. ("Pioneer"): (1) an international distribution agreement ("Distribution Agreement") and (2) a unit purchase agreement ("Purchase Agreement"). These agreements were combined and accounted for as one arrangement with one unit of accounting for revenue recognition purposes.
Pursuant to the terms of the Distribution Agreement. Pioneer has the right to distribute Neutrophase, upon MAA Approval from a Regulatory Authority, in certain territories in Asia (other than China). Upon execution of the Distribution Agreement, we received an upfront payment of $250,000 from Pioneer, which was initially recorded as deferred revenue; an additional $350,000 was due to us as of December 2012. This amount was recorded as deferred revenue at December 31, 2012 and was received in early January 2013. Pioneer is also obligated to make certain additional payments to us upon receipt of the MAA Approval. The Distribution Agreement further provides that Pioneer is entitled to a cumulative purchase discount not to exceed $500,000 upon the purchase of NeutroPhase product, payable in NovaBay unregistered restricted common stock.

Pursuant to the Purchase Agreement, we also received $2.5 million from Pioneer for the purchase of restricted units (comprising 1 share of common stock and a warrant for the purchase of 1 share of common stock). The unit purchase was completed in two tranches: (1) 800,000 units in September 2012 and (2) 1,200,000 units in October 2012, with both tranches at a purchase price of $1.25 per share. The fair value of the total units sold was $3.5 million, based upon the trading price of our common stock on the dates the units were purchased and fair value of the warrants based on the Black-Scholes Merton option pricing model. Because the aggregate fair value of the units on the dates of purchase exceeded the $2.5 million in proceeds received from the unit purchase by approximately $1 million, we reallocated $600,000 from deferred revenue to stockholders' equity as consideration for the purchase of the units.

During the three months ended March 31, 2013 and 2012, we recognized $0 and $10,000, respectively, related to the these agreements.

At March 31, 2013 and December 31, 2012, the Company had a deferred revenue balance of $583,000 related to the Pioneer partnership agreements.

Animal Health Agreement

In April 2012, the Company entered into a feasibility and option agreement with an animal health company for the development and potential commercialization of Aganocides for a number of veterinary uses. Under the terms of the agreement, NovaBay received an upfront payment and is entitled to additional support for research and development. The company will conduct veterinary studies using NovaBay's Aganocide compounds to assess the feasibility for treating several veterinary indications.

Revenue has been recognized under the agreement as follows:

	Three Months Ended March 31,	
(in thousands)	2013	2012
Amortization of Upfront Technology Access Fee	$38	$—
On-going Research and Development (FTE)	87	—
Total	$125	$—

The Company had deferred revenue balances of $0 and $125,000, respectively, at March 31, 2013 and December 31, 2012, related to this agreement, which consisted of the unamortized balances on the upfront technology and access fee and the support for ongoing research and development.

Private Label Agreement

In October 2012, NovaBay entered into a private label distribution agreement. Under the terms of that agreement NovaBay received an upfront payment and will receive an additional payment upon the first shipment of product under the agreement. In addition, NovaBay is entitled to additional support for research and development and product payments.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Revenue has been recognized under the agreement as follows:

	Three Months Ended March 31,	
(in thousands)	2013	2012
Amortization of Upfront Technology Access Fee	$10	$—
On-going Research and Development (FTE)	44	—
Total	$54	$—

The Company had deferred revenue balances of $273,000 and $226,000, respectively, at March 31, 2013 and December 31, 2012, related to this agreement, which consisted of the unamortized balances on the upfront technology and access fee and the support for ongoing research and development.

NOTE 10. SEGMENT INFORMATION

Beginning in 2012, the Company is reporting financial data for four reportable segments, coinciding with its four business units: dermatology, ophthalmology, urology and wound care. The dermatology segment includes all aspects of its business around the dermatology arena including the collaboration with Galderma and their impetigo clinical trial. The ophthalmology segment includes its clinical trial on ophthalmology which it is conducting on its own at this time. This segment also includes its i-case product which is currently in development phases. The urology segment covers its UCBE trials. The wound care segment encompasses the business around its NeutroPhase product, which went on the market in December 2012. Its remaining activities are immaterial and are shown as an aggregate.

The Company discloses information about its reportable segments based on the measures it uses in assessing the performance of each segment. The Company uses “segment net income (loss)” to measure the performance of its business units. Segment net income (loss) includes the allocation of certain corporate expense. These expenses have been allocated based on the FTE allocations to each individual segment or business unit.

The Company does not segregate specific assets to each business unit as we do not have a reasonable way to allocate the corporate assets to each unit and the Company does not use this as a measure of segment performance.

	Three Months Ended March 31,	
(in thousands)	2013	2012
Revenues:		
DermaBay (dermatology)	$735	$1,305
EyeBay (ophthalmology)	—	—
UroBay (urology)	—	—
MediBay (wound care)	117	11
Other	168	5
	$1,020	$1,321
Segment net income (loss):		
DermaBay (dermatology)	$4	$595
EyeBay (ophthalmology)	(1,348)	(733)

UroBay (urology)	(892)	(889)
MediBay (wound care)	(883)	(808)
Other	(368)	(650)
	$(3,487)	$(2,485)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A reconciliation of total segment net loss to consolidated net loss is as follows:

(in thousands)	Three Months ended March 31, 2013	2012
Segment net income (loss)	$(3,487)	(2,485)
Non-cash gain on change in fair value of warrants of warrants	(520)	(35)
Other income (expense), net	—	(5)
Provision for income taxes	(2)	(6)
Net loss	$(4,009)	$(2,531)

NOTE 11. SUBSEQUENT EVENTS

On March 29, 2013, the Company agreed to sell an aggregate of 300,000 shares of the Company's common stock to an accredited investor at a purchase price of $375,000, the shares were transferred and the cash was collected in April 2013.

We evaluated subsequent events through the issuance date of the consolidated financial statements. We are not aware of any significant events, other than those disclosed above, that occurred subsequent to the balance sheet date but prior to the filing of this Quarterly Report on Form 10-Q that would have a material impact on our consolidated financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements and related notes included in Part I, Item 1 of this report, and with our consolidated financial statements and related notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations, included in our Annual Report on Form 10-K for the year ended December 31, 2012, which was filed with the Securities and Exchange Commission on March 14, 2013. This discussion contains forward-looking statements that involve risks and uncertainties. Words such as "expects," "anticipated," "will," "may," "goals," "plans," "belie "estimates," variations of these words, and similar expressions are intended to identify these forward-looking statements. As a result of many factors, such as those set forth under the section entitled "Risk Factors" in Part II, Item 1A and elsewhere in this report, our actual results may differ materially from those anticipated in these forward-looking statements Readers are cautioned that these forward-looking statements are only predictions based upon assumptions made that we believed to be reasonable at the time, and are subject to risks and uncertainties. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements.

Overview

NovaBay Pharmaceuticals is a clinical-stage biotechnology company focused on addressing the large unmet therapeutic needs of the global anti-infective market with its two distinct categories of products.

Aganocide® Compounds

NovaBay's first-in-class Aganocide® compounds, led by auriclosene (NVC-422), are patented, synthetic molecules with a broad spectrum of activity against bacteria, viruses and fungi. Mimicking the mechanism of action that human white blood cells use against infections, Aganocides possess a reduced likelihood that bacteria or viruses will be able to develop resistance, which is critical for advanced anti-infectives. Having demonstrated therapeutic proof-of-concept in three Phase 2 clinical studies, these compounds are well suited to treat and prevent a wide range of local, non-systemic infections. NovaBay is currently focused in three large therapeutic markets:

- Dermatology - Partnered with Galderma, a leading dermatology company, the companies are developing a gel formulation of auriclosene (NVC-422) for treating the highly contagious skin infection, impetigo. A global Phase 2b clinical study is currently underway with results expected to be available in the second half of 2013.

- Ophthalmology - NovaBay is developing an eye drop formulation of auriclosene (NVC-422) for treating adenoviral conjunctivitis, for which there is currently no FDA-approved treatment. The company expects to complete a global Phase 2b clinical study for this indication in the last half of 2013. The company expects to initiate a proof-of-concept study for bacterial conjunctivitis in the second quarter of 2013 with the same auriclosene (NVC-422) formulation.

- Urology – NovaBay's urinary catheter irrigation solution containing auriclosene (NVC-422) is currently in Phase 2 clinical studies, with the goal of reducing the incidence of urinary catheter blockage and encrustation (UCBE) and the associated urinary tract infections. The company reported positive data from Part A of this study and expects to announce interim top-line results from Part B of this study mid year.

NeutroPhase®

NovaBay has developed NeutroPhase, which is a different class of molecule from the Aganocides. NeutroPhase is an FDA 510(k)-cleared Skin and Wound Cleanser. With a distinct mechanism of action from Aganocides, NeutroPhase is a patented pure hypochlorous acid solution and has the potential to be "best in class" skin and wound cleanser for wound care and is suited to treat the six-million-patients in the U.S. who suffer from chronic non-healing wounds, such as pressure, venous stasis and diabetic ulcers, surgical wound and burn.

NovaBay has begun securing commercial partnerships for NeutroPhase. In January 2012, NovaBay announced it had entered into a strategic marketing agreement with Pioneer Pharma Co., Ltd., a Shanghai-based company that markets high-end pharmaceutical products into China. In September 2012, the collaboration with Pioneer Pharma was expanded to include the Asian markets, Hong Kong, Macau, Taiwan, Singapore, Malaysia, Indonesia, Myanmar, Philippines, Thailand, Vietnam, Brunei, Cambodia and Laos. NovaBay expects to announce additional marketing agreements in select geographic markets around the world during 2013.

To date, we have generated very little revenue from product sales, and we have financed our operations and internal growth primarily through the sale of our capital stock, and the fees received from Galderma and Alcon, prior to the termination of our collaboration with Alcon Manufacturing Ltd. (Alcon), an affiliate of Alcon, Inc., in June 2011. As we are a development stage company, we have incurred significant losses since commencement of our operations in July 2002, since we have devoted substantially all of our resources to research and development. As of March 31, 2013, we had an accumulated deficit of $44.3 million. This deficit resulted from research and development expenses as well as general and administrative expenses. We expect to incur net losses over the next several years as we continue our clinical and research and development activities and as we apply for patents and regulatory approvals.

Recent Events

In April 2013, Shin Poong Pharmaceutical Co., Ltd. announced that it signed an exclusive distribution agreement for Shin Poong Pharma to commercialize NeutroPhase®, Skin and Wound Cleanser in South Korea for acute and chronic wounds.

In April 2013, we announced the enrollment of the first patients in Brazil into our global Phase 2b clinical trial, BAYnovation. The trial is investigating Auriclosene (NVC-422) Ophthalmic Solution as a treatment for adenoviral conjunctivitis, a highly contagious form of "pink eye" for which there is no approved treatment anywhere in the world.

In March 2013, we announced that Keith R. Bley, Ph.D., has joined NovaBay as Senior Vice President of Product Development, effective March 4, 2013. Dr. Bley has more than 20 years of experience in the pharmaceutical industry, management positions with increasing responsibility in research and product development.

In February 2013, we announced that the World Health Organization (WHO) has approved the international nonproprietary name (INN) "auriclosene" for our lead Aganocide® compound auriclosene (NVC-422). INNs facilitate the identification of active pharmaceutical ingredients, and each INN is a globally recognized unique name.

In February 2013, we announced that our partner Galderma S.A., a global leading pharmaceutical company exclusively focused on dermatology, had initiated the South African arm of its Phase 2b clinical study of a proprietary topical formulation of auriclosene (NVC-422) for the treatment of impetigo.

In January 2013 we announced that the first patients had been enrolled in India in our global Phase 2b BAYnovation clinical study, investigating Auriclosene (NVC-422) Ophthalmic Solution as a treatment of adenoviral conjunctivitis, a highly contagious form of "pink eye" for which there is an unmet ocular medical need.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim reporting. The preparation of these consolidated financial statements requires us to make estimates, assumptions and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported revenues and expenses during the reporting periods. In preparing these consolidated financial statements, management has made its best estimates and judgments of certain amounts included in the financial statements giving due consideration to materiality. On an ongoing basis, we evaluate our estimates and judgments related to revenue recognition, research and development costs, patent costs, stock-based compensation, income taxes and other contingencies. We base our estimates on historical experience and on various other factors that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our significant accounting policies are more fully described in Note 2 of the Notes to Consolidated Financial Statements (unaudited), included in Part I, Item 1 of this report, and are also described in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2012. We have not materially changed these policies from those reported in our Annual Report on Form 10-K for the year ended December 31, 2012.

Recent Accounting Pronouncements

See Note 2 to the accompanying unaudited consolidated financial statements included in Part I, Item 1 of this quarterly report on Form 10-Q for information on recent accounting pronouncements.

Results of Operations

Comparison of the Three Months Ended March 31, 2013, and March 31, 2012

License, Collaboration and Distribution Revenue

Total license, collaboration and distribution revenue was $914,000 for the three months ended March 31, 2013, compared to $1.3 million for the three months ended March 31, 2012.

License, collaboration and distribution revenue over the three months ended March 31, 2013, and 2012, is due to five different agreements entered into by NovaBay. Those agreements are:

- a license and collaboration agreement entered into with Galderma in 2009,
- a distribution agreement covering China entered into with Pioneer Pharma in Jan 2012,
- a private label distribution agreement entered into with a U.S.-based marketer of healthcare products and;
- a feasibility and option agreement with an animal health company.

The decrease in license, collaboration and distribution revenue was related to a decrease in reimbursable support costs from Galderma for support of the Impetigo trial as the trial progresses. We did not recognize any other significant revenues in for the three months ended March 31, 2013 and 2012.

Research and Development

Total research and development expenses increased by 29% to $2.9 million for the three months ended March 31, 2013, from $2.3 million for the three months ended March 31, 2012. The increase relates to the increase in clinical activities as we continue to conduct our BAYNovation for viral conjunctivitis and UCBE trials and scale up our production in anticipation of the Phase 3 impetigo trial to be conducted by Galderma. This increase in production will be partially reimbursed by Galderma in the future.

We expect to incur increasing research and development expenses throughout 2013 and in subsequent years as we continue to increase our focus on clinical trials and developing product candidates, both independently and in collaboration with Galderma. In particular, we expect to incur ongoing clinical and manufacturing expenses during 2013 in connection with our dermatology, ophthalmology and urology programs.

General and Administrative

General and administrative expenses remained relatively flat at $1.5 million for the three months ended March 31, 2013 and 2012. We expect general and administrative expenses to continue to remain relatively flat for the remainder of 2013 in comparison to 2012.

Non-Cash Loss on Increase in Fair Value of Warrants

The non-cash loss on increase in fair value of warrants relates to the fair value adjustment to the warrants issued with our July 2011 registered direct offering of common stock and warrants. This balance will fluctuate with market condition and the price of our stock.

Other Income (Expense), Net

Other income (expense), net was an expense of $0 for the three months ended March 31, 2013, compared to $5,000 for the three months ended March 31, 2012. This change was primarily attributable to fluctuation in the returns on our investments.

We expect that other income (expense), net will fluctuate based on our cash balances and the fluctuation in interest rates.

Liquidity and Capital Resources

As of March 31, 2013, we had cash, cash equivalents, and short-term investments of $13.2 million, compared to $16.9 million at December 31, 2012. We have incurred cumulative net losses of $44.3 million since inception through March 31, 2013. We do not expect to generate significant revenue from product candidates for several years. Since inception, we have funded our operations primarily through the sales of our stock and warrants and funds received under our collaboration agreements. We raised $47.9 million through sales of our equity through March 31, 2013. Our last public offering was in December 2012, in which we sold our common stock and warrants with gross proceeds of $7.4 million, or approximately $6.6 million in net proceeds after deducting underwriting commissions of $479,000 and other offering costs of $240,000. Additionally, cash received from our collaboration partners have totaled $62.0 million through March 31, 2013. Under the terms of our collaboration and license agreement with Galderma, Galderma will pay to NovaBay reimbursements, and milestone payments related to achieving development and commercialization of its Aganocide compounds. We believe the capital generated through these sources is sufficient to fund our planned operations into 2014. Our capital requirements going forward will depend on numerous factors including:

- the number and characteristics of product development programs we pursue and the pace of each program;
- the scope, rate of progress, results and costs of clinical trials;
- the time, cost and outcome involved in seeking regulatory approvals;
- our ability to establish and maintain strategic collaborations or partnerships for clinical trials, manufacturing and marketing of our product candidates; and
- the cost of establishing clinical and commercial supplies of our product candidates and any products that we may develop.

Cash Used in Operating Activities

For the three months ended March 31, 2013 cash used in operating activities of $3.7 million was primarily attributable to our research and development and general administrative expenses of operating the company.

Cash Used in Investing Activities

For the three months ended March 31, 2013, cash used by investing activities of $686,000 was attributable to net effect of purchases of short-term investments and sales and maturities.

Cash Provided by Financing Activities

Net cash provided by financing activities of $30,000 for the three months ended March 31, 2013, was primarily attributable proceeds from stock option exercises.

Net Operating Losses and Tax Credit Carryforwards

As of December 31, 2012, we had net operating loss carryforwards for federal and state income tax purposes of $33.8 million and $35.5 million, respectively. If not utilized, the federal and state net operating loss carryforwards will begin expiring at various dates between 2015 and 2032. As of December 31, 2012, we also had tax credit carryforwards for federal income tax purposes of $58,000.

Current federal and California tax laws include substantial restrictions on the utilization of net operating loss carryforwards in the event of an ownership change of a corporation. Accordingly, our ability to utilize net operating loss carryforwards may be limited as a result of such ownership changes. Such a limitation could result in the expiration of carryforwards before they are utilized.

Inflation

We do not believe that inflation has had a material impact on our business and operating results during the periods presented, and we do not expect it to have a material impact in the near future. There can be no assurances, however, that our business will not be affected by inflation.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

Contractual Obligations

Our commitments at March 31, 2013, consist of an operating lease. The operating lease consists of payments relating to the lease for various laboratory and office space in one office building in Emeryville, California. This lease expires on October 31, 2020, and the total commitment as of March 31, 2013 is $4.3 million due over the lease term, compared to $4.5 million as of December 31, 2012.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our market risk consists principally of interest rate risk on our cash, cash equivalents, and short-term investments. Our exposure to market risk is limited primarily to interest income sensitivity, which is affected by changes in interest rates, particularly because the majority of our investments are in short-term debt securities.

Our investment policy restricts our investments to high-quality investments and limits the amounts invested with any one issuer, industry, or geographic area. The goals of our investment policy are as follows: preservation of capital; assurance of liquidity needs; best available return on invested capital; and minimization of capital taxation. Some of the securities in which we invest may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with an interest rate fixed at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline. To minimize this risk, in accordance with our investment policy, we maintain our cash and cash equivalents in short-term marketable securities, including money market mutual funds, Treasury bills, Treasury notes, commercial paper, and corporate and municipal bonds. The risk associated with fluctuating interest rates is limited to our investment portfolio. Due to the short term nature of our investment portfolio, we believe we have minimal interest rate risk arising from our investments. As of March 31, 2013, and December 31, 2012, a 10% change in interest rates would have had an immaterial effect on the value of our short-term marketable securities. We do not use derivative financial instruments in our investment portfolio. We do not hold any instruments for trading purposes.

To date, we have operated exclusively in the United States and have not had any material exposure to foreign currency rate fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 and 15d-15 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Assessing the costs and benefits of such controls and procedures necessarily involves the exercise of judgment by management. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting during the quarter ended March 31, 2013, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

The risk factors facing our company have not changed materially from those set forth in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, as filed with the SEC on March 14, 2013, which risk factors are set forth below.

Our business is subject to a number of risks, the most important of which are discussed below. You should consider carefully the following risks in addition to the other information contained in this report and our other filings with the SEC, before deciding to buy, sell or hold our common stock. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently believe are not important may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected, the value of our common stock could decline and you may lose all or part of your investment.

Risks Relating to Our Business

Current worldwide economic conditions may limit our access to capital, adversely affect our business and financial condition, as well as further decrease our stock price.

General worldwide economic conditions have continued to be depressed due to the effects of the subprime lending crisis, general credit market crisis, the Greek debt crises and the effects that it has had on the Eurozone, collateral effects on the finance and banking industries, concerns about inflation, slower economic activity, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns. Although the impact of the downturn on our business is uncertain at this time, downturn may adversely affect our business and operations in a number of ways, including making it more difficult for us to raise capital as well as making it more difficult to enter into collaboration agreements with other parties. Like many other stocks, our stock price has been subject to fluctuations in recent months. Our stock price could decrease due to concerns that our business, operating results and financial condition will be negatively impacted by a worldwide economic downturn.

We may be unable to raise additional capital on acceptable terms in the future which may in turn limit our ability to develop and commercialize products and technologies.

While we have reduced our staff levels and reduced both our research and general expenditures, we expect our capital outlays and operating expenditures to increase over at least the next several years as we expand our clinical and regulatory activities. Conducting clinical trials is very expensive, and we expect that we will need to raise additional capital, through future private or public equity offerings, strategic alliances or debt financing, before we achieve commercialization of any of our Aganocide compounds. In addition, we may require even more significant capital outlays and operating expenditures if we do not continue to partner with third parties to develop and commercialize our products.

Our future capital requirements will depend on many factors, including:

- the extent to which we receive milestone payments or other funding from Galderma, if any;
- the scope, rate of progress and cost of our pre-clinical studies and clinical trials and other research and development activities;
- future clinical trial results;
- the terms and timing of any collaborative, licensing and other arrangements that we may establish;
- the cost and timing of regulatory approvals;
- the cost of establishing clinical and commercial supplies of our product candidates and any products that we may develop;
- the effect of competing technological and market developments;
- the cost of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights; and
- the extent to which we acquire or invest in businesses, products and technologies, although we currently have no commitments or agreements relating to any of these types of transactions.

We do not currently have any commitments for future external funding. Additional financing may not be available on favorable terms, or at all. Our ability to obtain additional financing may be negatively affected by the recent volatility in the financial markets, as well as the general downturn in the economy and decreased consumer confidence. Even if we succeed in selling additional securities to raise funds, our existing stockholders' ownership percentage would be diluted and new investors may demand rights, preferences or privileges senior to those of existing stockholders. If we raise additional capital through strategic alliance and licensing arrangements, we may have to trade our rights to our technology, intellectual property or products to others on terms that may not be favorable to us. If we raise additional capital through debt financing, the financing may involve covenants that restrict our business activities.

In addition, it is often the case that the cost of pharmaceutical development can be significantly greater than initially anticipated. This may be due to any of a large number of possible reasons, some of which could have been anticipated, while others may be caused by unpredictable circumstances. A significant increase in our costs would cause the amount of financing that would be required to enable us to achieve our goals to be likewise increased.

If we determine that we need to raise additional funds and we are not successful in doing so, we may be unable to complete the clinical development of some or all of our product candidates or to seek or obtain FDA approval of our product candidates. Such events could force us to discontinue product development, enter into a relationship with a strategic partner earlier than currently intended, reduce sales and marketing efforts or forego attractive business opportunities.

We are an early stage company with a history of losses and expect that we will incur net losses in the future, and that we may never achieve or maintain sustained profitability.

We have incurred net losses each year since our inception through December 31, 2012, with the exception of 2009. For the years ended December 31, 2012, 2011 and 2010, we had net losses of approximately $7.0 million, $5.1 million and 4.3 million, respectively, and for the year ended December 31, 2009, we had net income of $2.7 million. We were able to record a profit in 2009 due to our receipt of a $3.75 million milestone payment under our agreement with Galderma; however, there is no assurance that we will receive any additional large milestone payments under this agreement and, as a result, may not be able to achieve or maintain profitability in the future. We had a net loss of $4.0 million in the quarter ended March 31, 2013. Through March 31, 2013, we had an accumulated deficit of approximately $44.3 million. We have been, and expect to remain for the foreseeable future, mostly in a research and development stage as we proceed through clinical trials. We have incurred substantial research and development expenses, which were approximately $2.9 million, $9.3 million, $9.9 million and $8.6 million for the three months ended March 31, 2013, and the years ended December 31, 2012, 2011 and 2010, respectively. We expect to continue to make, for at least the next several years, significant expenditures for the development of products that incorporate our Aganocide compounds, as well as continued research into the biological activities of our Aganocide compounds, which expenditures are accounted for as research and development expenses. We expect to incur substantial losses for the foreseeable future, and we may never achieve or maintain sustained profitabilitborder-bottom:1px solid #000000;background-color:#cceeff;">

199

(3
)
Total temporarily impaired securities
3

$20,952

($54
)

12

$25,973

($4,982
)

15

$46,925

($5,036
)

Further deterioration in credit quality of the underlying issuers of the securities, further deterioration in the condition of the financial services industry, a continuation or worsening of the current economic environment, or additional declines in real estate values, among other things, may further affect the fair value of these securities and increase the potential that certain unrealized losses be designated as other-than-temporary in future periods, and the Corporation may incur additional write-downs.

Unrealized losses on temporarily impaired securities as of June 30, 2015 and December 31, 2014 were concentrated in variable rate trust preferred debt securities.

Trust Preferred Debt Securities of Individual Name Issuers

Included in debt securities in an unrealized loss position at June 30, 2015 were 10 trust preferred security holdings issued by 7 individual companies in the banking sector. Management believes the unrealized loss position in these holdings was attributable to the general widening of spreads for this category of debt securities issued by financial services companies since the time these securities were purchased. Based on the information available through the filing date of this report, all individual name issuer trust preferred debt securities held in our portfolio continue to accrue and make payments as expected with no payment deferrals or defaults on the part of the issuers. As of June 30, 2015, individual name issuer trust preferred debt securities with an amortized cost of $11.9 million and unrealized losses of $1.6 million were rated below investment grade by Standard & Poors, Inc. ("S&P"). Management reviewed the collectibility of these securities taking into consideration such factors as the financial condition of the issuers, reported regulatory capital ratios of the issuers, credit ratings, including ratings in effect as of the reporting period date as well as credit rating changes between the reporting period date and the filing date of this report, and other information. We noted no additional downgrades to below investment grade between December 31, 2014 and the filing date of this report. Based on these analyses, management concluded that it expects to recover the entire amortized cost basis of these securities. Furthermore, Washington Trust does not intend to sell these securities and it is not more likely than not that Washington Trust will be required to sell these securities before recovery of their cost basis, which may be maturity. Therefore, management does not consider these investments to be other-than-temporarily impaired at June 30, 2015.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(5) Loans

The following is a summary of loans:

(Dollars in thousands)	June 30, 2015			December 31, 2014		
	Amount	%		Amount	%	
Commercial:						
Mortgages (1)	$876,589	30	%	$843,978	30	%
Construction & development (2)	110,989	4		79,592	3	
Commercial & industrial (3)	595,959	20		611,918	21	
Total commercial	1,583,537	54		1,535,488	54	
Residential real estate:						
Mortgages	971,705	33		948,731	33	
Homeowner construction	29,558	1		36,684	1	
Total residential real estate	1,001,263	34		985,415	34	
Consumer:						
Home equity lines	249,845	9		242,480	8	
Home equity loans	47,437	2		46,967	2	
Other (4)	46,502	1		48,926	2	
Total consumer	343,784	12		338,373	12	
Total loans (5)	$2,928,584	100	%	$2,859,276	100	%

(1) Loans primarily secured by income producing property.

(2) Loans for construction of commercial properties, loans to developers for construction of residential properties and loans for land development.

(3) Loans to businesses and individuals, a substantial portion of which are fully or partially collateralized by real estate.

(4) Consumer installment loans and loans secured by general aviation aircraft and automobiles.

(5) Includes net unamortized loan origination costs of $2.5 million and $2.1 million, respectively, and net unamortized premiums on purchased loans of $91 thousand and $94 thousand, respectively, at June 30, 2015 and December 31, 2014.

At June 30, 2015 and December 31, 2014, there were $1.24 billion and $1.21 billion, respectively, of loans pledged as collateral to the FHLBB under a blanket pledge agreement and to the FRB for the discount window. See Note 8 for additional disclosure regarding borrowings.

Nonaccrual Loans

Loans, with the exception of certain well-secured loans that are in the process of collection, are placed on nonaccrual status and interest recognition is suspended when such loans are 90 days or more overdue with respect to principal and/or interest, or sooner if considered appropriate by management. Well-secured loans are permitted to remain on accrual status provided that full collection of principal and interest is assured and the loan is in the process of collection. Loans are also placed on nonaccrual status when, in the opinion of management, full collection of principal and interest is doubtful. Interest previously accrued but not collected on such loans is reversed against current period income. Subsequent interest payments received on nonaccrual loans are applied to the outstanding principal balance of the loan or recognized as interest income depending on management’s assessment of the ultimate collectibility of the loan. Loans are removed from nonaccrual status when they have been current as to principal and interest for approximately six months, the borrower has demonstrated an ability to comply with repayment terms, and when, in management’s opinion, the loans are considered to be fully collectible.

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Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

The following is a summary of nonaccrual loans, segregated by class of loans:

(Dollars in thousands)	Jun 30, 2015	Dec 31, 2014
Commercial:		
Mortgages	$4,915	$5,315
Construction & development	—	—
Commercial & industrial	1,039	1,969
Residential real estate:		
Mortgages	7,411	7,124
Homeowner construction	—	—
Consumer:		
Home equity lines	526	1,217
Home equity loans	960	317
Other	280	3
Total nonaccrual loans	$15,131	$15,945
Accruing loans 90 days or more past due	$—	$—

As of June 30, 2015 and December 31, 2014, nonaccrual loans of $2.7 million and $3.2 million, respectively, were current as to the payment of principal and interest.

At June 30, 2015, there were no significant commitments to lend additional funds to borrowers whose loans were on nonaccrual status.

Past Due Loans

Past due status is based on the contractual payment terms of the loan. The following tables present an age analysis of past due loans, segregated by class of loans:

(Dollars in thousands)	Days Past Due					
June 30, 2015	30-59	60-89	Over 90	Total Past Due	Current	Total Loans
Commercial:						
Mortgages	$14	$—	$4,915	$4,929	$871,660	$876,589
Construction & development	—	—	—	—	110,989	110,989
Commercial & industrial	2,581	2,299	638	5,518	590,441	595,959
Residential real estate:						
Mortgages	5,120	913	4,871	10,904	960,801	971,705
Homeowner construction	—	—	—	—	29,558	29,558
Consumer:						
Home equity lines	1,098	74	50	1,222	248,623	249,845
Home equity loans	527	315	348	1,190	46,247	47,437
Other	9	8	249	266	46,236	46,502
Total loans	$9,349	$3,609	$11,071	$24,029	$2,904,555	$2,928,584

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(Dollars in thousands)	Days Past Due					
December 31, 2014	30-59	60-89	Over 90	Total Past Due	Current	Total Loans
Commercial:						
Mortgages	$—	$—	$5,315	$5,315	$838,663	$843,978
Construction & development	—	—	—	—	79,592	79,592
Commercial & industrial	2,136	1,202	181	3,519	608,399	611,918
Residential real estate:						
Mortgages	2,943	821	3,284	7,048	941,683	948,731
Homeowner construction	—	—	—	—	36,684	36,684
Consumer:						
Home equity lines	570	100	841	1,511	240,969	242,480
Home equity loans	349	240	56	645	46,322	46,967
Other	35	5	—	40	48,886	48,926
Total loans	$6,033	$2,368	$9,677	$18,078	$2,841,198	$2,859,276

Included in past due loans as of June 30, 2015 and December 31, 2014, were nonaccrual loans of $12.4 million and $12.7 million, respectively. All loans 90 days or more past due at June 30, 2015 and December 31, 2014 were classified as nonaccrual.

Impaired Loans

Impaired loans consist of nonaccrual commercial loans, troubled debt restructured loans and other loans classified as impaired that are individually evaluated for impairment. Impaired loans are loans for which it is probable that the Corporation will not be able to collect all amounts due according to the contractual terms of the loan agreements and loans restructured in a troubled debt restructuring. Impaired loans do not include large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, which consist of most residential mortgage loans and consumer loans.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

The following is a summary of impaired loans:

(Dollars in thousands)	Recorded Investment (1)		Unpaid Principal		Related Allowance	
	Jun 30, 2015	Dec 31, 2014	Jun 30, 2015	Dec 31, 2014	Jun 30, 2015	Dec 31, 2014
No Related Allowance Recorded:						
Commercial:						
Mortgages	$205	$432	$205	$432	$—	$—
Construction & development	—	—	—	—	—	—
Commercial & industrial	1,454	1,047	1,479	1,076	—	—
Residential real estate:						
Mortgages	1,596	1,477	1,893	1,768	—	—
Homeowner construction	—	—	—	—	—	—
Consumer:						
Home equity lines	—	—	—	—	—	—
Home equity loans	—	—	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	3,255	2,956	3,577	3,276	—	—
With Related Allowance Recorded:						
Commercial:						
Mortgages	$14,183	$14,585	$14,564	$14,564	$1,177	$927
Construction & development	—	—	—	—	—	—
Commercial & industrial	1,795	1,878	2,113	2,437	69	177
Residential real estate:						
Mortgages	1,509	2,226	1,552	2,338	233	326
Homeowner construction	—	—	—	—	—	—
Consumer:						
Home equity lines	311	250	317	250	72	141
Home equity loans	88	45	107	62	—	12
Other	397	112	397	114	102	—
Subtotal	18,283	19,096	19,050	19,765	1,653	1,583
Total impaired loans	$21,538	$22,052	$22,627	$23,041	$1,653	$1,583
Total:						
Commercial	$17,637	$17,942	$18,361	$18,509	$1,246	$1,104
Residential real estate	3,105	3,703	3,445	4,106	233	326
Consumer	796	407	821	426	174	153
Total impaired loans	$21,538	$22,052	$22,627	$23,041	$1,653	$1,583

(1) The recorded investment in impaired loans consists of unpaid principal balance net of charge-offs, interest payments received applied to principal and unamortized deferred loan origination fees and costs. For impaired accruing loans (troubled debt restructurings for which management has concluded that the collectibility of the loan is not in doubt), the recorded investment also includes accrued interest.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

The following tables present the average recorded investment balance of impaired loans and interest income recognized on impaired loans segregated by loan class:

(Dollars in thousands)	Average Recorded Investment		Interest Income Recognized	
Three months ended June 30,	2015	2014	2015	2014
Commercial:				
Mortgages	$14,556	$25,093	$76	$240
Construction & development	—	—	—	—
Commercial & industrial	3,077	2,492	41	15
Residential real estate:				
Mortgages	3,251	4,452	24	36
Homeowner construction	—	—	—	—
Consumer:				
Home equity lines	278	60	—	—
Home equity loans	78	157	1	2
Other	191	118	2	2
Totals	$21,431	$32,372	$144	$295

(Dollars in thousands)	Average Recorded Investment		Interest Income Recognized	
Six months ended June 30,	2015	2014	2015	2014
Commercial:				
Mortgages	$14,748	$26,707	$155	$405
Construction & development	—	—	—	—
Commercial & industrial	3,057	2,429	60	38
Residential real estate:				
Mortgages	3,354	4,100	40	50
Homeowner construction	—	—	—	—
Consumer:				
Home equity lines	263	97	—	2
Home equity loans	76	126	1	3
Other	169	122	5	4
Totals	$21,667	$33,581	$261	$502

Troubled Debt Restructurings

Loans are considered restructured in a troubled debt restructuring when the Corporation has granted concessions to a borrower due to the borrower's financial condition that it otherwise would not have considered. These concessions may include modifications of the terms of the debt such as deferral of payments, extension of maturity, reduction of principal balance, reduction of the stated interest rate other than normal market rate adjustments, or a combination of these concessions. Debt may be bifurcated with separate terms for each tranche of the restructured debt. Restructuring a loan in lieu of aggressively enforcing the collection of the loan may benefit the Corporation by increasing the ultimate probability of collection.

Restructured loans are classified as accruing or non-accruing based on management's assessment of the collectibility of the loan. Loans which are already on nonaccrual status at the time of the restructuring generally remain on nonaccrual status for approximately six months before management considers such loans for return to accruing status. Accruing restructured loans

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

are placed into nonaccrual status if and when the borrower fails to comply with the restructured terms and management deems it unlikely that the borrower will return to a status of compliance in the near term.

Troubled debt restructurings are reported as such for at least one year from the date of the restructuring. In years after the restructuring, troubled debt restructured loans are removed from this classification if the restructuring did not involve a below-market rate concession and the loan is not deemed to be impaired based on the terms specified in the restructuring agreement.

Troubled debt restructurings are classified as impaired loans. The Corporation identifies loss allocations for impaired loans on an individual loan basis. The recorded investment in troubled debt restructurings was $17.6 million and $18.4 million, respectively, at June 30, 2015 and December 31, 2014. These amounts included insignificant balances of accrued interest. The allowance for loan losses included specific reserves for these troubled debt restructurings of $1.3 million and $1.2 million, respectively, at June 30, 2015 and December 31, 2014. As of June 30, 2015, there were no significant commitments to lend additional funds to borrowers whose loans had been restructured.

The following tables present loans modified as a troubled debt restructuring:

(Dollars in thousands)			Outstanding Recorded Investment (1)			
	# of Loans		Pre-Modifications		Post-Modifications	
Three months ended June 30,	2015	2014	2015	2014	2015	2014
Commercial:						
Mortgages	—	—	$—	$—	$—	$—
Construction & development	—	—	—	—	—	—
Commercial & industrial	2	9	284	763	284	763
Residential real estate:						
Mortgages	—	—	—	—	—	—
Homeowner construction	—	—	—	—	—	—
Consumer:						
Home equity lines	—	—	—	—	—	—
Home equity loans	1	—	70	—	70	—
Other	—	—	—	—	—	—
Totals	3	9	$354	$763	$354	$763

(1) The recorded investment in troubled debt restructurings consists of unpaid principal balance, net of charge-offs and unamortized deferred loan origination fees and costs, at the time of the restructuring. For accruing troubled debt restructured loans, the recorded investment also includes accrued interest.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(Dollars in thousands)			Outstanding Recorded Investment (1)			
	# of Loans		Pre-Modifications		Post-Modifications	
Six months ended June 30,	2015	2014	2015	2014	2015	2014
Commercial:						
Mortgages	—	—	$—	$—	$—	$—
Construction & development	—	—	—	—	—	—
Commercial & industrial	3	9	584	763	584	763
Residential real estate:						
Mortgages	1	2	93	479	93	479
Homeowner construction	—	—	—	—	—	—
Consumer:						
Home equity lines	—	—	—	—	—	—
Home equity loans	1	—	70	—	70	—
Other	1	—	35	—	35	—
Totals	6	11	$782	$1,242	$782	$1,242

(1) The recorded investment in troubled debt restructurings consists of unpaid principal balance, net of charge-offs and unamortized deferred loan origination fees and costs, at the time of the restructuring. For accruing troubled debt restructured loans, the recorded investment also includes accrued interest.

The following table presents information on how loans were modified as a troubled debt restructuring:
(Dollars in thousands)

	Three months		Six months	
Periods ended June 30,	2015	2014	2015	2014
Below-market interest rate concession	$—	$77	$—	$77
Payment deferral	284	—	619	479
Maturity / amortization concession	70	599	163	599
Interest only payments	—	—	—	—
Combination (1)	—	87	—	87
Total	$354	$763	$782	$1,242

(1) Loans included in this classification were modified with a combination of any two of the concessions listed in this table.

In the three and six months ended June 30, 2015 and 2014, there were an insignificant amount of loans modified in a troubled debt restructuring within the previous 12 months for which there were payment defaults.

Credit Quality Indicators

Commercial

The Corporation utilizes an internal rating system to assign a risk to each of its commercial loans. Loans are rated on a scale of 1 to 10. This scale can be assigned to three broad categories including "pass" for ratings 1 through 6, "special mention" for 7-rated loans, and "classified" for loans rated 8, 9 or 10. The loan rating system takes into consideration parameters including the borrower's financial condition, the borrower's performance with respect to loan terms, the adequacy of collateral, the adequacy of guarantees and other credit quality characteristics. As of June 30, 2015 and December 31, 2014, the weighted average risk rating of the Corporation's commercial loan portfolio was 4.68 and 4.67, respectively. For non-impaired loans, the Corporation assigns a loss allocation factor to each loan, based on its risk rating for purposes of establishing an appropriate allowance for loan losses. See Note 6 for additional information.

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Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

A description of the commercial loan categories are as follows:

Pass - Loans with acceptable credit quality, defined as ranging from superior or very strong to a status of lesser stature. Superior or very strong credit quality is characterized by a high degree of cash collateralization or strong balance sheet liquidity. Lesser stature loans have an acceptable level of credit quality but exhibit some weakness in various credit metrics such as collateral adequacy, cash flow, secondary sources of repayment, or performance inconsistency or may be in an industry or of a loan type known to have a higher degree of risk.

Special Mention - Loans with potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's position as creditor at some future date. Special Mention assets are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification. Examples of these conditions include but are not limited to outdated or poor quality financial data, strains on liquidity and leverage, losses or negative trends in operating results, marginal cash flow, weaknesses in occupancy rates or trends in the case of commercial real estate and frequent delinquencies.

Classified - Loans identified as "substandard", "doubtful" or "loss" based on criteria consistent with guidelines provided by banking regulators. A "substandard" loan has defined weaknesses which make payment default or principal exposure likely, but not yet certain. Such loans are apt to be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. The loans are closely watched and are either already on nonaccrual status or may be placed on nonaccrual status when management determines there is uncertainty of collectibility. A "doubtful" loan is placed on non-accrual status and has a high probability of loss, but the extent of the loss is difficult to quantify due to dependency upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. A loan in the "loss" category is considered generally uncollectible or the timing or amount of payments cannot be determined. "Loss" is not intended to imply that the loan has no recovery value but rather it is not practical or desirable to continue to carry the asset.

The Corporation's procedures call for loan ratings and classifications to be revised whenever information becomes available that indicates a change is warranted. The criticized loan portfolio, which consists of commercial loans that are risk rated special mention or worse, are reviewed by management on a quarterly basis, focusing on the current status and strategies to improve the credit. An annual loan review program is conducted by a third party to provide an independent evaluation of the creditworthiness of the commercial loan portfolio, the quality of the underwriting and credit risk management practices and the appropriateness of the risk rating classifications. This review is supplemented with selected targeted internal reviews of the commercial loan portfolio.

The following table presents the commercial loan portfolio, segregated by category of credit quality indicator:

(Dollars in thousands)	Pass		Special Mention		Classified	
	Jun 30, 2015	Dec 31, 2014	Jun 30, 2015	Dec 31, 2014	Jun 30, 2015	Dec 31, 2014
Mortgages	$858,908	$819,857	$12,566	$18,372	$5,115	$5,749
Construction & development	110,989	79,592	—	—	—	—
Commercial & industrial	570,867	592,206	22,318	16,311	2,774	3,401
Total commercial loans	$1,540,764	$1,491,655	$34,884	$34,683	$7,889	$9,150

Residential and Consumer

The residential and consumer portfolios are monitored on an ongoing basis by the Corporation using delinquency information and loan type as credit quality indicators. These credit quality indicators are assessed on an aggregate basis in these relatively homogeneous portfolios. For non-impaired loans, the Corporation assigns loss allocation factors to each respective loan type and delinquency status. See Note 6 for additional information.

Various other techniques are utilized to monitor indicators of credit deterioration in the portfolios of residential real estate mortgages and home equity lines and loans. Among these techniques is the periodic tracking of loans with an updated FICO score and an estimated loan to value (“LTV”) ratio. LTV is determined via statistical modeling analyses. The indicated LTV levels are estimated based on such factors as the location, the original LTV, and the date of origination of the loan and do not reflect actual appraisal amounts. The results of these analyses and other loan review procedures are taken into consideration in

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

the determination of loss allocation factors for residential mortgage and home equity consumer credits. See Note 6 for additional information.

The following table presents the residential and consumer loan portfolios, segregated by category of credit quality indicator:

(Dollars in thousands)	Current and Under 90 Days Past Due		Over 90 Days Past Due	
	Jun 30, 2015	Dec 31, 2014	Jun 30, 2015	Dec 31, 2014
Residential real estate:				
Accruing mortgages	$964,294	$941,607	$—	$—
Nonaccrual mortgages	2,540	3,840	4,871	3,284
Homeowner construction	29,558	36,684	—	—
Total residential loans	$996,392	$982,131	$4,871	$3,284
Consumer:				
Home equity lines	$249,795	$241,639	$50	$841
Home equity loans	47,089	46,911	348	56
Other	46,253	48,926	249	—
Total consumer loans	$343,137	$337,476	$647	$897

(6) Allowance for Loan Losses

The allowance for loan losses is management's best estimate of the inherent risk of loss in the loan portfolio as of the balance sheet date. The allowance is increased by provisions charged to earnings and by recoveries of amounts previously charged off, and is reduced by charge-offs on loans. The Corporation uses a methodology to systematically measure the amount of estimated loan loss exposure inherent in the loan portfolio for purposes of establishing a sufficient allowance for loan losses. The methodology includes three elements: (1) identification of loss allocations for individual loans deemed to be impaired, (2) application of loss allocation factors for non-impaired loans based on credit grade, historical loss experience, estimated loss emergence period and delinquency status, with adjustments for various exposures not adequately presented in historical loss experience, and (3) an unallocated allowance maintained for measurement imprecision associated with impaired and nonaccrual loans.

Prior to December 31, 2014, the unallocated allowance included amounts for management's qualitative and quantitative assessment of certain other loan portfolio risks not captured in other components of the allowance. The 2014 presentation of the allowance for loan losses by portfolio segment, set forth below, has been revised to conform to the December 31, 2014 presentation format. The reclassification resulted in a reduction of $5.0 million in the unallocated allowance previously reported as of June 30, 2014, with a corresponding increase to the allowance by portfolio segment. The reclassification resulted in no change in the total allowance.

Loss allocations for loans deemed to be impaired are measured on a discounted cash flow method based upon the loan's contractual effective interest rate, or at the loan's observable market price, or, if the loan is collateral dependent, at the fair value of the collateral. For collateral dependent loans for which repayment is dependent on the sale of the collateral, management adjusts the fair value for estimated costs to sell. For collateral dependent loans for which repayment is dependent on the operation of the collateral, such as accruing troubled debt restructured loans, estimated costs to sell are not incorporated into the measurement. Management may also adjust appraised values to reflect estimated market value declines or apply other discounts to appraised values for unobservable factors resulting from its knowledge of circumstances associated with the property.

Individual commercial loans not deemed to be impaired are evaluated using an internal rating system and the application of loss allocation factors. The loan rating system is described under the caption “Credit Quality Indicators” in Note 5. The loan rating system and the related loss allocation factors take into consideration parameters including the borrower’s financial condition, the borrower’s performance with respect to loan terms, the adequacy of collateral and the adequacy of guarantees. We periodically reassess and revise the loss allocation factors used in the assignment of loss exposure to appropriately reflect our analysis of migrational loss experience. Revisions to loss allocation factors are not retroactively applied. We analyze historical loss experience over periods deemed to be relevant to the inherent risk of loss in the commercial loan portfolio and the related estimate

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

of the loss emergence period as of the balance sheet date. We also adjust loss factor allocations for various exposures we believe are not adequately presented in historical loss experience, including our assessments of credit risk associated with certain industries, an ongoing trend toward larger credit relationships, recent changes in portfolio composition, conditions that may affect the ability of borrowers to meet debt service requirements and trends in rental rates on commercial real estate.

Portfolios of more homogeneous populations of loans, including the various categories of residential mortgages and consumer loans, are analyzed as groups, with loss allocation factors assigned to each group based on account delinquency status. We periodically reassess and revise the loss allocation factors. Revisions to loss allocation factors are not retroactively applied. We analyze historical loss experience over periods deemed to be relevant to the inherent risk of loss in residential mortgage and consumer loan portfolios and the related estimate of the loss emergence period as of the balance sheet date. We also adjust loss factor allocations for various exposures we believe are not adequately presented in historical loss experience including trends in real estate values, conditions that may affect the collateral position, consideration of general economic conditions, increases in delinquency levels and regulatory changes affecting the foreclosure process. These matters are also evaluated taking into account the geographic location of the underlying loans.

Because the methodology is based upon historical experience and trends, current economic data as well as management's judgment, factors may arise that result in different estimations. Significant factors that could give rise to changes in these estimates may include, but are not limited to, changes in economic conditions in our market area, concentration of risk and declines in local property values. Adversely different conditions or assumptions could lead to increases in the allowance. In addition, various regulatory agencies periodically review the allowance for loan losses. Such agencies may require additions to the allowance based on their judgments about information available to them at the time of their examination.

The following table presents the activity in the allowance for loan losses for three months ended June 30, 2015:

(Dollars in thousands)	Commercial							
	Mortgages	Construction	C&I (1)	Total Commercial	Residential	Consumer	Un-allocated	Total
Beginning Balance	$8,331	$1,229	$7,803	$17,363	$5,355	$2,731	$2,361	$27,810
Charge-offs	(200)	—	(44)	(244)	(6)	(105)	—	(355)
Recoveries	4	—	18	22	2	8	—	32
Provision	394	455	(767)	82	54	49	(85)	100
Ending Balance	$8,529	$1,684	$7,010	$17,223	$5,405	$2,683	$2,276	$27,587

(1) Commercial & industrial loans.

The following table presents the activity in the allowance for loan losses for three months ended June 30, 2014:

(Dollars in thousands)	Commercial							
	Mortgages	Construction	C&I (1)	Total Commercial	Residential	Consumer	Un-allocated	Total
Beginning Balance	$6,547	$269	$8,470	$15,286	$7,148	$2,577	$2,032	$27,043

Charge-offs	(32)	—	(115)	(147)	(30)	(90)	—	(267)
Recoveries	6	—	20	26	—	17	—	43
Provision	1,671	225	(487)	1,409	(927)	73	(105)	450
Ending Balance	$8,192	$494	$7,888	$16,574	$6,191	$2,577	$1,927	$27,269

(1) Commercial & industrial loans.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

The following table presents the activity in the allowance for loan losses for six months ended June 30, 2015:

(Dollars in thousands)	Commercial							
	Mortgages	Construction	C&I (1)	Total Commercial	Residential	Consumer	Un-allocated	Total
Beginning Balance	$8,202	$1,300	$7,987	$17,489	$5,430	$2,713	$2,391	$28,023
Charge-offs	(400)	—	(51)	(451)	(54)	(171)	—	(676)
Recoveries	84	—	32	116	4	20	—	140
Provision	643	384	(958)	69	25	121	(115)	100
Ending Balance	$8,529	$1,684	$7,010	$17,223	$5,405	$2,683	$2,276	$27,587

(1) Commercial & industrial loans.

The following table presents the activity in the allowance for loan losses for six months ended June 30, 2014:

(Dollars in thousands)	Commercial							
	Mortgages	Construction	C&I (1)	Total Commercial	Residential	Consumer	Un-allocated	Total
Beginning Balance	$8,022	$383	$7,835	$16,240	$6,450	$2,511	$2,685	$27,886
Charge-offs	(977)	—	(311)	(1,288)	(72)	(130)	—	(1,490)
Recoveries	12	—	46	58	35	30	—	123
Provision	1,135	111	318	1,564	(222)	166	(758)	750
Ending Balance	$8,192	$494	$7,888	$16,574	$6,191	$2,577	$1,927	$27,269

(1) Commercial & industrial loans.

The following table presents the Corporation’s loan portfolio and associated allowance for loan loss by portfolio segment and by impairment methodology:

(Dollars in thousands)	June 30, 2015		December 31, 2014	
	Loans	Related Allowance	Loans	Related Allowance
Loans Individually Evaluated for Impairment:				
Commercial:				
Mortgages	$14,363	$1,177	$14,991	$927
Construction & development	—	—	—	—
Commercial & industrial	3,248	69	2,921	177
Residential real estate	3,103	233	3,698	326
Consumer	795	174	409	153
Subtotal	$21,509	$1,653	$22,019	$1,583
Loans Collectively Evaluated for Impairment:				
Commercial:				
Mortgages	$862,226	$7,352	$828,987	$7,275
Construction & development	110,989	1,684	79,592	1,300
Commercial & industrial	592,711	6,941	608,997	7,810
Residential real estate	998,160	5,172	981,717	5,104
Consumer	342,989	2,509	337,964	2,560
Subtotal	$2,907,075	$23,658	$2,837,257	$24,049

Unallocated	—	2,276	—	2,391
Total	$2,928,584	$27,587	$2,859,276	$28,023

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(7) Time Certificates of Deposit

The following table presents scheduled maturities of time certificates of deposit:

(Dollars in thousands)	Scheduled Maturity	Weighted Average Rate	
July 1, 2015 to December 31, 2015	$236,141	0.71	%
2016	198,094	0.94	
2017	156,885	0.93	
2018	78,699	1.65	
2019	121,956	1.75	
2020 and thereafter	42,225	0.65	
Balance at June 30, 2015	$834,000	1.04	%

(8) Borrowings

Federal Home Loan Bank Advances

Advances payable to the FHLBB amounted to $471.3 million and $406.3 million, respectively, at June 30, 2015 and December 31, 2014.

The following table presents maturities and weighted average interest rates on FHLBB advances outstanding as of June 30, 2015:

(Dollars in thousands)	Total Outstanding	Weighted Average Rate	
July 1, 2015 to December 31, 2015	$219,672	0.37	%
2016	43,783	0.96	%
2017	30,071	2.88	%
2018	70,653	2.40	%
2019	42,652	3.79	%
2020 and thereafter	64,490	3.76	%
Balance at June 30, 2015	$471,321	1.66	%

As of June 30, 2015 and December 31, 2014, the Bank also has access to an unused line of credit with the FHLBB amounting to $40.0 million. In addition, the FHLBB has issued standby letters of credit to depositor customers of the Bank to collateralize public deposits. The Bank’s FHLBB borrowings, line of credit and letters of credit are collateralized by a blanket pledge agreement on the Bank’s FHLBB stock, certain qualified investment securities and loans, as well as amounts maintained on deposit at the FHLBB. The Bank’s unused remaining available borrowing capacity at the FHLBB was approximately $537.0 million and $569.4 million, respectively, at June 30, 2015 and December 31, 2014.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(9) Shareholders' Equity

Regulatory Capital Requirements

The following table presents the Corporation's and the Bank's actual capital amounts and ratios, as well as the corresponding minimum required capital ratios and minimum capital ratios required for the Bank to be "well capitalized" for purposes of the Federal Deposit Insurance Corporation's ("FDIC") prompt corrective action provisions:

(Dollars in thousands)	Actual			For Capital Adequacy Purposes			To Be "Well Capitalized" Under Prompt Corrective Action Provisions	
	Amount	Ratio		Amount	Ratio		Amount	Ratio
June 30, 2015								
Total Capital (to Risk-Weighted Assets):								
Corporation	$358,896	12.78	%	$224,669	8.00	%	N/A	N/A
Bank	354,710	12.63		224,613	8.00		280,766	10.00
Tier 1 Capital (to Risk-Weighted Assets):								
Corporation	330,973	11.79		168,502	6.00		N/A	N/A
Bank	326,787	11.64		168,460	6.00		224,613	8.00
Common Equity Tier 1 Capital (to Risk-Weighted Assets): (1)								
Corporation	308,974	11.00		126,376	4.50		N/A	N/A
Bank	326,787	11.64		126,345	4.50		182,498	6.50
Tier 1 Capital (to Average Assets): (2)								
Corporation	330,973	9.31		142,262	4.00		N/A	N/A
Bank	326,787	9.20		142,145	4.00		177,681	5.00
December 31, 2014								
Total Capital (to Risk-Weighted Assets):								
Corporation	343,934	12.56		219,149	8.00		N/A	N/A
Bank	339,268	12.39		219,075	8.00		273,844	10.00
Tier 1 Capital (to Risk-Weighted Assets):								
Corporation	315,575	11.52		109,574	4.00		N/A	N/A
Bank	310,909	11.35		109,537	4.00		164,306	6.00
Tier 1 Capital (to Average Assets): (2)								
Corporation	315,575	9.14		138,090	4.00		N/A	N/A
Bank	310,909	9.01		137,964	4.00		172,454	5.00

(1) New capital ratio effective January 1, 2015 under the Basel III capital requirements. See additional discussion of Basel III and the new regulatory capital requirements in the "Supervision and Regulation" section in the Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

(2) Leverage ratio.

(10) Derivative Financial Instruments

The Corporation's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Corporation's known or expected cash receipts and its known or expected cash payments principally to manage the Corporation's interest rate risk. Additionally, the Corporation enters into interest rate derivatives to accommodate the business requirements of its customers. All derivatives are recognized as either assets or liabilities on the balance sheet and are measured at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and resulting designation.

Interest Rate Risk Management Agreements

Interest rate swaps are used from time to time as part of the Corporation's interest rate risk management strategy. Swaps are agreements in which the Corporation and another party agree to exchange interest payments (e.g., fixed-rate for variable-rate payments) computed on a notional principal amount. The credit risk associated with swap transactions is the risk of default by the counterparty. To minimize this risk, the Corporation enters into interest rate agreements only with highly rated counterparties that management believes to be creditworthy. The notional amounts of these agreements do not represent amounts exchanged by the parties and, thus, are not a measure of the potential loss exposure.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

Cash Flow Hedging Instruments

As of June 30, 2015 and December 31, 2014, the Bancorp had two interest rate swap contracts designated as cash flow hedges to hedge the interest rate associated with $22.7 million of variable rate junior subordinated debentures. The effective portion of the changes in fair value of derivatives designated as cash flow hedges is recorded in other comprehensive income and subsequently reclassified to earnings when gains or losses are realized. The ineffective portion of changes in fair value of the derivatives is recognized directly in earnings as interest expense. As of June 30, 2015 and December 31, 2014, the Bancorp has pledged collateral to derivative counterparties in the form of cash totaling $800 thousand and $939 thousand, respectively. The Bancorp may need to post additional collateral in the future in proportion to potential increases in unrealized loss positions.

Customer Related Derivative Contracts

The Corporation has entered into interest rate swap contracts to help commercial loan borrowers manage their interest rate risk. The interest rate swap contracts with commercial loan borrowers allow them to convert floating-rate loan payments to fixed-rate loan payments. When we enter into an interest rate swap contract with a commercial loan borrower, we simultaneously enter into a “mirror” swap contract with a third party. The third party exchanges the client’s fixed rate loan payments for floating-rate loan payments. We retain the risk that is associated with the potential failure of counterparties and the risk inherent in originating loans. As of June 30, 2015 and December 31, 2014, Washington Trust had interest rate swap contracts with commercial loan borrowers with notional amounts of $231.2 million and $165.8 million, respectively, and equal amounts of “mirror” swap contracts with third-party financial institutions. These derivatives are not designated as hedges and therefore, changes in fair value are recognized in earnings.

Risk Participation Agreements

During 2015, the Corporation entered into risk participation agreements (“RPAs”) with other banks participating in commercial loan arrangements. Participating banks guarantee the performance on borrower-related interest rate swap contracts. RPAs are derivative financial instruments and are recorded at fair value. Changes in the fair value of the derivative assets and liabilities are recognized in earnings in the period of change.

Under a risk participation-out agreement, a derivative asset, the Corporation participates out a portion of the credit risk associated with the interest rate swap position executed with the commercial borrower, for a fee paid to the participating bank. Under a risk participation-in agreement, a derivative liability, the Corporation assumes, or participates in, a portion of the credit risk associated with the interest rate swap position with the commercial borrower, for a fee received from the other bank.

As of June 30, 2015, the notional amounts of the risk participation-out agreements and risk participation-in agreements were $19.4 million and $7.2 million, respectively.

Loan Commitments

Interest rate lock commitments are extended to borrowers and relate to the origination of residential real estate mortgage loans held for sale. To mitigate the interest rate risk inherent in these rate locks, as well as closed residential real estate mortgage loans held for sale, forward commitments are established to sell individual residential real estate mortgage loans. Both interest rate lock commitments and commitments to sell residential real estate mortgage loans are derivative financial instruments, but do not meet criteria for hedge accounting and, as such are treated as derivatives not designated as hedging instruments. These derivative financial instruments are recorded at fair value and changes in fair value of these commitments are reflected in earnings in the period of change. The Corporation has elected to carry certain closed residential real estate mortgage loans held for sale at fair value, as changes in fair value in these loans held for sale generally offset changes in interest rate lock and forward sale commitments.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

The following table presents the fair values of derivative instruments in the Corporation's Consolidated Balance Sheets:

(Dollars in thousands)	Asset Derivatives			Liability Derivatives		
		Fair Value			Fair Value	
	Balance Sheet Location	Jun 30, 2015	Dec 31, 2014	Balance Sheet Location	Jun 30, 2015	Dec 31, 2014
Derivatives Designated as Cash Flow Hedging Instruments:						
Interest rate risk management contracts:						
Interest rate swap contracts	Other assets	$—	$—	Other liabilities	$226	$497
Derivatives not Designated as Hedging Instruments:						
Forward loan commitments:						
Interest rate lock commitments	Other assets	1,336	1,212	Other liabilities	5	20
Commitments to sell mortgage loans	Other assets	112	13	Other liabilities	1,657	2,028
Customer related derivative contracts:						
Interest rate swaps with customers	Other assets	5,148	4,554	Other liabilities	51	23
Mirror swaps with counterparties	Other assets	145	28	Other liabilities	5,224	4,748
Risk participation agreements	Other assets	39	—	Other liabilities	21	—
Total		$6,780	$5,807		$7,184	$7,316

The following tables present the effect of derivative instruments in the Corporation's Consolidated Statements of Income and Changes in Shareholders' Equity:

(Dollars in thousands)	Gain (Loss) Recognized in Other Comprehensive Income (Effective Portion)				Location of Gain (Loss) Recognized in Income (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Gain (Loss) Recognized in Income (Ineffective Portion)			
	Three months		Six months			Three months		Six months	
Periods ended June 30,	2015	2014	2015	2014		2015	2014	2015	2014
Derivatives Designated as Cash Flow Hedging Instruments:									
Interest rate risk management contracts:									
Interest rate swap contracts	$89	$79	$174	$155	Interest Expense	$—	$—	$—	$—
Total	$89	$79	$174	$155		$—	$—	$—	$—

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(Dollars in thousands)		Amount of Gain (Loss) Recognized in Income on Derivative		Amount of Gain (Loss) Recognized in Income on Derivative	
		Three months		Six months	
Periods ended June 30,	Statement of Income Location	2015	2014	2015	2014
Derivatives not Designated as Hedging Instruments:					
Forward loan commitments:					
Interest rate lock commitments	Net gains on loan sales & commissions on loans originated for others	($432)	$326	$139	$603
Commitments to sell mortgage loans	Net gains on loan sales & commissions on loans originated for others	1,410	(753)	470	(1,066)
Customer related derivative contracts:					
Interest rate swaps with customers	Net gains on interest rate swap contracts	(1,365)	1,120	2,268	2,150
Mirror swaps with counterparties	Net gains on interest rate swap contracts	2,118	(1,157)	(718)	(1,927)
Risk participation agreements	Net gains on interest rate swap contracts	(36)	—	(188)	—
Total		$1,695	($464)	$1,971	($240)

(11) Fair Value Measurements

The Corporation uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. As of June 30, 2015 and December 31, 2014, securities available for sale, certain residential real estate mortgage loans held for sale and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other assets on a nonrecurring basis, such as collateral dependent impaired loans, property acquired through foreclosure or repossession, certain residential real estate mortgage loans held for sale and mortgage servicing rights. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write-downs of individual assets.

Fair value is a market-based measurement, not an entity-specific measurement. Fair value measurements are determined based on the assumptions the market participants would use in pricing the asset or liability. In addition, GAAP specifies a hierarchy of valuation techniques based on whether the types of valuation information ("inputs") are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Corporation's market assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 – Quoted prices for identical assets or liabilities in active markets.
- Level 2 – Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.
- Level 3 – Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable in the markets and which reflect the Corporation's market assumptions.

Fair Value Option Election

GAAP allows for the irrevocable option to elect fair value accounting for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. The Corporation elected the fair value option for certain residential real estate mortgage loans held for sale to better match changes in fair value of the loans with changes in the fair value of the derivative loan sale contracts used to economically hedge them.

The aggregate principal amount of the residential real estate mortgage loans held for sale recorded at fair value was $17.1 million and $29.5 million, respectively, at June 30, 2015 and December 31, 2014. The aggregate fair value of these loans as of the same dates was $17.3 million and $30.3 million, respectively. As of June 30, 2015 and December 31, 2014, the aggregate fair value of residential real estate mortgage loans held for sale exceeded the aggregate principal amount by $210 thousand and $779 thousand, respectively.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

There were no residential real estate mortgage loans held for sale 90 days or more past due as of June 30, 2015 and December 31, 2014.

The following table presents the changes in fair value related to mortgage loans held for sale, interest rate lock commitments and commitments to sell residential real estate mortgage loans, for which the fair value option was elected. Changes in fair values are reported as a component of net gains on loan sales and commissions on loans originated for others in the Consolidated Statements of Income.
(Dollars in thousands)

	Three Months		Six months	
Periods ended June 30,	2015	2014	2015	2014
Mortgage loans held for sale	($910)	$387	($569)	$463
Interest rate lock commitments	(432)	326	139	603
Commitments to sell mortgage loans	1,410	(753)	470	(1,066)
Total changes in fair value	$68	($40)	$40	$—

Items Measured at Fair Value on a Recurring Basis
Securities
Securities available for sale are recorded at fair value on a recurring basis. When available, the Corporation uses quoted market prices to determine the fair value of securities; such items are classified as Level 1. There were no Level 1 securities held at June 30, 2015 and December 31, 2014.

Level 2 securities include debt securities with quoted prices, which are traded less frequently than exchange-traded instruments, whose value is determined using matrix pricing with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes obligations of U.S. government-sponsored enterprises, mortgage backed securities issued by U.S. government agencies and U.S. government sponsored enterprises, obligations of states and political subdivisions, individual name issuer trust preferred debt securities and corporate bonds.

Securities not actively traded whose fair value is determined through the use of cash flows utilizing inputs that are unobservable are classified as Level 3. There were no Level 3 securities held at June 30, 2015 and December 31, 2014.

Mortgage Loans Held for Sale
The fair values of mortgage loans held for sale are generally estimated based on secondary market rates offered for loans with similar characteristics. When secondary market information exists, these loans are classified as Level 2. In certain cases when quoted market prices are not available, fair value is determined by utilizing a discounted cash flow analysis and these assets are classified as Level 3. Any changes in the valuation of mortgage loans held for sale is based upon the change in market interest rates between the loan closing date and the measurement date and an immaterial portion attributable to changes in instrument-specific credit risk. There were no Level 3 mortgage loans held for sale at June 30, 2015 and December 31, 2014.

Derivatives
Interest rate swap contracts are traded in over-the-counter markets where quoted market prices are not readily available. Fair value measurements are determined using independent pricing models that utilize primarily market observable inputs, such as swap rates of different maturities and LIBOR rates and, accordingly, are classified as Level 2. The Corporation also evaluates the credit risk of its counterparties as well as that of the Corporation. Accordingly, Washington Trust considers factors such as the likelihood of default by the Corporation

and its counterparties, its net exposures and remaining contractual life, among other factors, in determining if any fair value adjustments related to credit risk are required. Counterparty exposure is evaluated by netting positions that are subject to master netting agreements, as well as considering the amount of collateral securing the position.

Level 2 fair value measurements of forward loan commitments (interest rate lock commitments and commitments to sell residential real estate mortgages) are estimated using the anticipated market price based on pricing indications provided by other financial institutions. In certain cases when quoted market prices are not available, fair value is determined by utilizing a discounted cash flow analysis and these assets are classified as Level 3. There were no Level 3 forward loan commitments held at June 30, 2015 and December 31, 2014.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

Items Measured at Fair Value on a Nonrecurring Basis
Collateral Dependent Impaired Loans
Collateral dependent loans that are deemed to be impaired are valued based upon the fair value of the underlying collateral. Such collateral primarily consists of real estate and, to a lesser extent, other business assets. For collateral dependent loans for which repayment is dependent on the sale of the collateral, management adjusts the fair value for estimated costs to sell. For collateral dependent loans for which repayment is dependent on the operation of the collateral, such as accruing troubled debt restructured loans, estimated costs to sell are not incorporated into the measurement. Management may also adjust appraised values to reflect estimated market value declines or apply other discounts to appraised values resulting from its knowledge of the property. Internal valuations are utilized to determine the fair value of other business assets. Collateral dependent impaired loans are categorized as Level 3.

Property Acquired Through Foreclosure or Repossession
Property acquired through foreclosure or repossession included in other assets in the Consolidated Balance Sheets is adjusted to fair value less costs to sell upon transfer out of loans through a charge to allowance for loan losses. Subsequently, it is carried at the lower of carrying value or fair value less costs to sell. Such subsequent valuation charges are charged through earnings. Fair value is generally based upon appraised values of the collateral. Management may adjust appraised values to reflect estimated market value declines or apply other discounts to appraised values for unobservable factors resulting from its knowledge of the property, and such property is categorized as Level 3.

Items Recorded at Fair Value on a Recurring Basis
The following tables present the balances of assets and liabilities reported at fair value on a recurring basis:

(Dollars in thousands) June 30, 2015	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Securities available for sale:				
Obligations of U.S. government-sponsored enterprises	$61,254	$—	$61,254	$—
Mortgage-backed securities issued by U.S. government agencies and U.S. government-sponsored enterprises	216,620	—	216,620	—
Obligations of states and political subdivisions	40,674	—	40,674	—
Individual name issuer trust preferred debt securities	26,724	—	26,724	—
Corporate bonds	6,106	—	6,106	—
Mortgage loans held for sale	17,260	—	17,260	—
Derivative assets (1)	6,780	—	6,780	—
Total assets at fair value on a recurring basis	$375,418	$—	$375,418	$—
Liabilities:				
Derivative liabilities (2)	$7,184	$—	$7,184	$—
Total liabilities at fair value on a recurring basis	$7,184	$—	$7,184	$—

(1) Derivative assets include interest rate swaps contracts with customers, risk participation-out agreements and forward loan commitments and are included in other assets in the Consolidated Balance Sheets.

(2) Derivative liabilities include mirror swaps with counterparties, risk participation-in agreements, interest rate risk management contracts and forward loan commitments and are included in other liabilities in the Consolidated

Balance Sheets.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(Dollars in thousands) December 31, 2014	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Securities available for sale:				
Obligations of U.S. government-sponsored enterprises	$31,172	$—	$31,172	$—
Mortgage-backed securities issued by U.S. government agencies and U.S. government-sponsored enterprises	245,366	—	245,366	—
Obligations of states and political subdivisions	49,176	—	49,176	—
Individual name issuer trust preferred debt securities	25,774	—	25,774	—
Corporate bonds	6,174	—	6,174	—
Mortgage loans held for sale	30,321	—	30,321	—
Derivative assets (1)	5,807	—	5,807	—
Total assets at fair value on a recurring basis	$393,790	$—	$393,790	$—
Liabilities:				
Derivative liabilities (2)	$7,316	$—	$7,316	$—
Total liabilities at fair value on a recurring basis	$7,316	$—	$7,316	$—

(1) Derivative assets include interest rate swaps contracts with customers and forward loan commitments and are included in other assets in the Consolidated Balance Sheets.

(2) Derivative liabilities include mirror swaps with counterparties, interest rate risk management contracts and forward loan commitments and are included in other liabilities in the Consolidated Balance Sheets.

It is the Corporation's policy to review and reflect transfers between Levels as of the financial statement reporting date. During the six months ended June 30, 2015 and 2014, there were no transfers in and/or out of Level 1, 2 or 3.

Items Recorded at Fair Value on a Nonrecurring Basis

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from the application of lower of cost or market accounting or write-downs of individual assets. The valuation methodologies used to measure these fair value adjustments are described above.

The following table summarizes the carrying value of such assets held at June 30, 2015, which were written down to fair value during the six months ended June 30, 2015:

(Dollars in thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Collateral dependent impaired loans	$4,291	$—	$—	$4,291
Property acquired through foreclosure or repossession	536	—	—	536
Total assets at fair value on a nonrecurring basis	$4,827	$—	$—	$4,827

The allowance for loan losses on collateral dependent impaired loans amounted to $1.3 million at June 30, 2015.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

The following table summarizes the carrying value of such assets held at December 31, 2014, which were written down to fair value during the year ended December 31, 2014:

(Dollars in thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Collateral dependent impaired loans	$5,728	$—	$—	$5,728
Property acquired through foreclosure or repossession	348	—	—	348
Total assets at fair value on a nonrecurring basis	$6,076	$—	$—	$6,076

The allowance for loan losses on collateral dependent impaired loans amounted to $1.3 million at December 31, 2014.

The following tables present valuation techniques and unobservable inputs for assets measured at fair value on a nonrecurring basis for which the Corporation has utilized Level 3 inputs to determine fair value:

(Dollars in thousands) June 30, 2015	Fair Value	Valuation Technique	Unobservable Input	Range of Inputs Utilized (Weighted Average)
Collateral dependent impaired loans	$4,291	Appraisals of collateral	Discount for costs to sell	0% - 15% (14%)
			Appraisal adjustments (1)	0% - 25% (2%)
Property acquired through foreclosure or repossession	$536	Appraisals of collateral	Discount for costs to sell	0% - 10% (3%)
			Appraisal adjustments (1)	10% - 32% (17%)

(1) Management may adjust appraisal values to reflect market value declines or other discounts resulting from its knowledge of the property.

(Dollars in thousands) December 31, 2014	Fair Value	Valuation Technique	Unobservable Input	Range of Inputs Utilized (Weighted Average)
Collateral dependent impaired loans	$5,728	Appraisals of collateral	Discount for costs to sell	0% - 10% (2%)
			Appraisal adjustments (1)	0% - 40% (3%)
Property acquired through foreclosure or repossession	$348	Appraisals of collateral	Discount for costs to sell	6% - 10% (8%)
			Appraisal adjustments (1)	5% - 23% (14%)

(1) Management may adjust appraisal values to reflect market value declines or other discounts resulting from its knowledge of the property.

Valuation of Other Financial Instruments

The methodologies for estimating the fair value of financial instruments that are measured at fair value on a recurring or nonrecurring basis are discussed above. The methodologies for other financial instruments are discussed below.

Loans

Fair values are estimated for categories of loans with similar financial characteristics. Loans are segregated by type and are then further segmented into fixed-rate and adjustable-rate interest terms to determine their fair value. The fair value of fixed-rate commercial and consumer loans is calculated by discounting scheduled cash flows through the estimated maturity of the loan using interest rates offered at the measurement date that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Corporation’s historical repayment experience. For residential mortgages, fair value is estimated by using market prices for sales of similar loans on the secondary market. The fair value of floating rate commercial and consumer loans approximates carrying value. Fair value for impaired loans is estimated using a discounted cash flow method based upon the loan’s contractual effective interest rate, or at the loan’s observable market price, or if the loan is collateral dependent, at the fair value of the collateral. Loans are classified within Level 3 of the fair value hierarchy.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

Time Deposits
The discounted values of cash flows using the rates currently offered for deposits of similar remaining maturities were used to estimate the fair value of time deposits. Time deposits are classified within Level 2 of the fair value hierarchy.

Federal Home Loan Bank Advances
Rates currently available to the Corporation for advances with similar terms and remaining maturities are used to estimate fair value of existing advances. FHLBB advances are categorized as Level 2.

Junior Subordinated Debentures
The fair value of the junior subordinated debentures is estimated using rates currently available to the Corporation for debentures with similar terms and maturities. Junior subordinated debentures are categorized as Level 2.

The following tables present the carrying amount, estimated fair value and placement in the fair value hierarchy of the Corporation's financial instruments. The tables exclude financial instruments for which the carrying value approximates fair value. Financial assets for which the fair value approximates carrying value include cash and cash equivalents, FHLBB stock, accrued interest receivable and bank-owned life insurance. Financial liabilities for which the fair value approximates carrying value include non-maturity deposits and accrued interest payable.
(Dollars in thousands)

June 30, 2015	Carrying Amount	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Securities held to maturity	$22,523	$23,091	$—	$23,091	$—
Loans, net of allowance for loan losses	2,900,997	2,928,971	—	—	2,928,971
Financial Liabilities:					
Time deposits	$834,000	$834,797	$—	$834,797	$—
FHLBB advances	471,321	483,964	—	483,964	—
Junior subordinated debentures	22,681	16,711	—	16,711	—

(Dollars in thousands)

December 31, 2014	Carrying Amount	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Securities held to maturity	$25,222	$26,008	$—	$26,008	$—
Loans, net of allowance for loan losses	2,831,253	2,866,907	—	—	2,866,907
Financial Liabilities:					

Time deposits	$874,102	$872,570	$—	$872,570	$—
FHLBB advances	406,297	418,005	—	418,005	—
Junior subordinated debentures	22,681	17,201	—	17,201	—

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(12) Defined Benefit Pension Plans
The Corporation maintains a tax-qualified defined benefit pension plan for the benefit of certain eligible employees who were hired prior to October 1, 2007. The Corporation also has non-qualified retirement plans to provide supplemental retirement benefits to certain employees, as defined in the plans. Defined benefit pension plans were previously amended to freeze benefit accruals after a 10-year transition period ending in December 2023.

The composition of net periodic benefit cost was as follows:

(Dollars in thousands)	Qualified Pension Plan				Non-Qualified Retirement Plans			
	Three months		Six months		Three months		Six months	
Periods ended June 30,	2015	2014	2015	2014	2015	2014	2015	2014
Net Periodic Benefit Cost:								
Service cost	$614	$538	$1,229	$1,076	$19	$11	$39	$23
Interest cost	732	722	1,464	1,445	123	119	245	239
Expected return on plan assets	(1,128)	(1,015)	(2,257)	(2,031)	—	—	—	—
Amortization of prior service (credit) cost	(5)	(5)	(11)	(11)	—	—	—	—
Recognized net actuarial loss	312	115	624	230	61	19	122	35
Net periodic benefit cost	$525	$355	$1,049	$709	$203	$149	$406	$297

The pension plan is funded on a current basis, in compliance with the requirements of ERISA.

(13) Share-Based Compensation Arrangements
Stock Options
During the six months ended June 30, 2015, the Corporation granted an executive officer 4,000 non-qualified stock options with 5-year cliff vesting. The grant-date fair value of stock options of $11.26 was estimated using the Black-Scholes Option-Pricing Model.

Nonvested Shares
During the six months ended June 30, 2015, the Corporation granted to non-employee directors and a certain executive officer 9,500 nonvested share units, with 3- to 5-year cliff vesting. The weighted average grant date fair value of the nonvested share units was $37.80.

Nonvested Performance Shares
During the six months ended June 30, 2015, performance share awards were granted to certain executive officers providing the opportunity to earn shares of common stock of the Corporation. The performance shares awarded were valued at the fair market value as of the award date, or $38.02, and will be earned over a 3-year performance period. The number of shares earned will range from zero to 200% of the target number of shares dependent upon the Corporation’s core return on equity and core earnings per share growth ranking compared to an industry peer group. The current assumption based on the most recent peer group information available results in shares earned at 150% of the target, or 46,950 shares.

(14) Business Segments
Washington Trust segregates financial information in assessing its results among its Commercial Banking and Wealth Management Services operating segments. The amounts in the Corporate unit include activity not related to the segments. The methodologies and organizational hierarchies that define the business segments are periodically reviewed and revised. Results may be restated, when necessary, to reflect changes in organizational structure or allocation methodology. Any changes in estimates and allocations that may affect the reported results of any business

segment will not affect the consolidated financial position or results of operations of Washington Trust as a whole.

Management uses certain methodologies to allocate income and expenses to the business lines. A funds transfer pricing methodology is used to assign interest income and interest expense to each interest-earning asset and interest-bearing liability on a matched maturity funding basis. Certain indirect expenses are allocated to segments. These include support unit expenses such as technology and processing operations and other support functions.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

Commercial Banking
The Commercial Banking segment includes commercial, residential and consumer lending activities; equity in losses of unconsolidated investments in real estate limited partnerships; mortgage banking, secondary market and loan servicing activities; deposit generation; merchant credit card services; cash management activities; and direct banking activities, which include the operation of ATMs, telephone and Internet banking services and customer support and sales.

Wealth Management Services
Wealth Management Services includes investment management; financial planning; personal trust services, including services as trustee, administrator, custodian and guardian; and estate settlement. Institutional trust services are also provided, including fiduciary services.

Corporate
Corporate includes the Treasury Unit, which is responsible for managing the wholesale investment portfolio and wholesale funding needs. It also includes income from bank-owned life insurance, net gain on sale of business line as well as administrative and executive expenses not allocated to the operating segments and the residual impact of methodology allocations such as funds transfer pricing offsets.

The following tables present the statement of operations and total assets for Washington Trust's reportable segments:

(Dollars in thousands)	Commercial Banking		Wealth Management Services		Corporate		Consolidated Total	
Three months ended June 30,	2015	2014	2015	2014	2015	2014	2015	2014
Net interest income (expense)	$21,212	$19,799	($9)	($7)	$4,825	$4,676	$26,028	$24,468
Provision for loan losses	100	450	—	—	—	—	100	450
Net interest income (expense) after provision for loan losses	21,112	19,349	(9)	(7)	4,825	4,676	25,928	24,018
Noninterest income	5,588	3,860	8,912	8,530	761	424	15,261	12,814
Noninterest expenses:								
Depreciation and amortization expense	638	621	299	272	51	52	988	945
Other noninterest expenses (1)	13,868	13,219	6,465	5,482	2,978	2,802	23,311	21,503
Total noninterest expenses	14,506	13,840	6,764	5,754	3,029	2,854	24,299	22,448
Income before income taxes	12,194	9,369	2,139	2,769	2,557	2,246	16,890	14,384
Income tax expense	3,993	3,102	838	1,018	556	467	5,387	4,587
Net income	$8,201	$6,267	$1,301	$1,751	$2,001	$1,779	$11,503	$9,797

Total assets at period end	$3,058,410	$2,704,109	$53,236	$53,303	$532,831	$559,610	$3,644,477	$3,317,022
Expenditures for long-lived assets	$943	$1,308	$87	$65	$88	$17	$1,118	$1,390

(1) Other noninterest expenses for the Wealth Management Services segment includes $433 thousand of acquisition related expenses for the three months ended June 30, 2015. See Note 19 for additional information.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(Dollars in thousands)	Commercial Banking		Wealth Management Services		Corporate		Consolidated Total	
Six months ended June 30,	2015	2014	2015	2014	2015	2014	2015	2014
Net interest income (expense)	$41,837	$39,538	($23)	($11)	$9,916	$8,777	$51,730	$48,304
Provision for loan losses	100	750	—	—	—	—	100	750
Net interest income (expense) after provision for loan losses	41,737	38,788	(23)	(11)	9,916	8,777	51,630	47,554
Noninterest income	10,666	8,401	17,347	16,595	1,268	7,188	29,281	32,184
Noninterest expenses:								
Depreciation and amortization expense	1,310	1,206	605	583	111	103	2,026	1,892
Other noninterest expenses (1)	27,454	26,772	12,380	10,869	5,970	12,207	45,804	49,848
Total noninterest expenses	28,764	27,978	12,985	11,452	6,081	12,310	47,830	51,740
Income before income taxes	23,639	19,211	4,339	5,132	5,103	3,655	33,081	27,998
Income tax expense	7,723	6,363	1,682	1,894	1,163	646	10,568	8,903
Net income	$15,916	$12,848	$2,657	$3,238	$3,940	$3,009	$22,513	$19,095
Total assets at period end	$3,058,410	$2,704,109	$53,236	$53,303	$532,831	$559,610	$3,644,477	$3,317,022
Expenditures for long-lived assets	2,010	2,383	201	236	133	62	2,344	2,681

(1) Other noninterest expenses for the Wealth Management Services segment includes $433 thousand of acquisition related expenses for the six months ended June 30, 2015. See Note 19 for additional information.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(15) Other Comprehensive Income (Loss)
The following tables present the activity in other comprehensive income (loss):

Three months ended June 30,	2015			2014		
(Dollars in thousands)	Pre-tax Amounts	Income Taxes	Net of Tax	Pre-tax Amounts	Income Taxes	Net of Tax
Securities available for sale:						
Net change in fair value of securities available for sale	($2,614)	($913)	($1,701)	$2,837	$1,020	$1,817
Cash flow hedges:						
Change in fair value of cash flow hedges	26	27	(1)	19	33	(14)
Net cash flow hedge losses reclassified into earnings (1)	141	51	90	145	52	93
Net change in fair value of cash flow hedges	167	78	89	164	85	79
Defined benefit plan obligation adjustment (2)	368	14	354	127	46	81
Total other comprehensive (loss) income	($2,079)	($821)	($1,258)	$3,128	$1,151	$1,977

(1) Included in interest expense on junior subordinated debentures in the Consolidated Statements of Income.
(2) Included in salaries and employee benefits expense in the Consolidated Statements of Income.

Six months ended June 30,	2015			2014		
(Dollars in thousands)	Pre-tax Amounts	Income Taxes	Net of Tax	Pre-tax Amounts	Income Taxes	Net of Tax
Securities available for sale:						
Net change in fair value of securities available for sale	($1,562)	($525)	($1,037)	$3,801	$1,372	$2,429
Cash flow hedges:						
Change in fair value of cash flow hedges	(6)	3	(9)	(24)	6	(30)
Net cash flow hedge losses reclassified into earnings (1)	286	103	183	290	105	185
Net change in fair value of cash flow hedges	280	106	174	266	111	155
Defined benefit plan obligation adjustment (2)	735	146	589	254	85	169
Total other comprehensive (loss) income	($547)	($273)	($274)	$4,321	$1,568	$2,753

(1) Included in interest expense on junior subordinated debentures in the Consolidated Statements of Income.
(2) Included in salaries and employee benefits expense in the Consolidated Statements of Income.

The following tables present the changes in accumulated other comprehensive income (loss) by component, net of tax:

(Dollars in thousands)	Net Unrealized Gains on Available For Sale Securities	Net Unrealized Losses on Cash Flow Hedges	Pension Benefit Adjustment	Total
Balance at December 31, 2014	$4,222	($287)	($12,744)	($8,809)
Other comprehensive income (loss) before reclassifications	(1,037)	(9)	—	(1,046)
Amounts reclassified from accumulated other comprehensive income	—	183	589	772
Net other comprehensive (loss) income	(1,037)	174	589	(274)
Balance at June 30, 2015	$3,185	($113)	($12,155)	($9,083)

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(Dollars in thousands)	Net Unrealized Gains on Available For Sale Securities	Net Unrealized Losses on Cash Flow Hedges	Pension Benefit Adjustment	Total
Balance at December 31, 2013	$3,201	($618)	($4,136)	($1,553)
Other comprehensive income (loss) before reclassifications	2,429	(30)	—	2,399
Amounts reclassified from accumulated other comprehensive income	—	185	169	354
Net other comprehensive income	2,429	155	169	2,753
Balance at June 30, 2014	$5,630	($463)	($3,967)	$1,200

(16) Earnings Per Common Share

Washington Trust utilizes the two-class method earnings allocation formula to determine earnings per share of each class of stock according to dividends and participation rights in undistributed earnings. Share-based payments that entitle holders to receive non-forfeitable dividends before vesting are considered participating securities and included in earnings allocation for computing basic earnings per share under this method. Undistributed income is allocated to common shareholders and participating securities under the two-class method based upon the proportion of each to the total weighted average shares available.

The following table presents the calculation of earnings per common share:
(Dollars and shares in thousands, except per share amounts)

	Three Months		Six months	
Periods ended June 30,	2015	2014	2015	2014
Earnings per common share - basic:				
Net income	$11,503	$9,797	$22,513	$19,095
Less dividends and undistributed earnings allocated to participating securities	(34)	(33)	(73)	(73)
Net income applicable to common shareholders	$11,469	$9,764	$22,440	$19,022
Weighted average common shares	16,811	16,678	16,785	16,653
Earnings per common share - basic	$0.68	$0.59	$1.34	$1.14
Earnings per common share - diluted:				
Net income	$11,503	$9,797	$22,513	$19,095
Less dividends and undistributed earnings allocated to participating securities	(33)	(33)	(72)	(74)
Net income applicable to common shareholders	$11,470	$9,764	$22,441	$19,021
Weighted average common shares	16,811	16,678	16,785	16,653
Dilutive effect of common stock equivalents	178	153	192	164
Weighted average diluted common shares	16,989	16,831	16,977	16,817
Earnings per common share - diluted	$0.68	$0.58	$1.32	$1.13

Weighted average common stock equivalents, not included in common stock equivalents above because they were anti-dilutive, totaled 27,169 and 54,556, respectively, for the three months ended June 30, 2015 and 2014. These amounts were 75,913 and 54,578, respectively, for the six months ended June 30, 2015 and 2014.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

(17) Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to manage the Corporation’s exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, standby letters of credit, interest rate swap agreements and interest rate lock commitments and commitments to sell residential real estate mortgage loans. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the Corporation’s Consolidated Balance Sheets. The contract or notional amounts of these instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments. The Corporation’s credit policies with respect to interest rate swap agreements with commercial borrowers, commitments to extend credit, and financial guarantees are similar to those used for loans. The interest rate swaps with other counterparties are generally subject to bilateral collateralization terms.

The following table presents the contractual and notional amounts of financial instruments with off-balance sheet risk:

(Dollars in thousands)	Jun 30, 2015	Dec 31, 2014
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit:		
Commercial loans	$347,236	$325,402
Home equity lines	204,471	200,932
Other loans	45,258	48,551
Standby letters of credit	5,402	5,102
Financial instruments whose notional amounts exceed the amount of credit risk:		
Forward loan commitments:		
Interest rate lock commitments	61,107	40,015
Commitments to sell mortgage loans	98,122	84,808
Customer related derivative contracts:		
Interest rate swaps with customers	231,205	165,795
Mirror swaps with counterparties	231,205	165,795
Risk participation-in agreements	7,174	—
Interest rate risk management contracts:		
Interest rate swaps	22,681	22,681

See Note 10 for additional disclosure pertaining to derivative financial instruments.

Commitments to Extend Credit

Commitments to extend credit are agreements to lend to a customer as long as there are no violations of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, total commitment amounts do not necessarily represent future cash requirements. Each borrower’s creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained is based on management’s credit evaluation of the borrower.

Standby Letters of Credit

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These standby letters of credit are primarily issued to support the financing needs of the Bank’s commercial customers. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loan facilities to customers. The collateral supporting those commitments is essentially the same as for other commitments. Most standby letters of credit extend for one year. As of June 30, 2015 and December 31, 2014, the maximum potential amount of undiscounted future payments, not reduced by amounts that may be recovered, totaled $5.4 million and $5.1 million, respectively. At June 30, 2015 and December 31, 2014, there were no liabilities to beneficiaries resulting from standby letters of credit. Fee income on standby letters of credit was insignificant for the three and six months ended June 30, 2015 and 2014.

Condensed Notes to Unaudited Consolidated Financial Statements – (continued)

Forward Loan Commitments
Interest rate lock commitments are extended to borrowers and relate to the origination of residential real estate mortgage loans held for sale. To mitigate the interest rate risk inherent in these rate locks, as well as closed residential real estate mortgage loans held for sale, forward commitments are established to sell individual residential real estate mortgage loans. Both interest rate lock commitments and commitments to sell residential real estate mortgage loans are derivative financial instruments.

Leases
As of June 30, 2015 and December 31, 2014, the Corporation was obligated under various non-cancellable operating leases for properties used as banking offices and other office facilities. Lease expiration dates range from 3 months to 26 years, with renewal options on certain leases of 6 months to 25 years. Rental expense under the operating leases amounted to $861 thousand and $1.7 million for the three and six months ended June 30, 2015, compared to $744 thousand and $1.5 million for the same period in 2014. Rental expense is recorded as a component of net occupancy expense in the accompanying Consolidated Statements of Income. There have been no significant changes in the future minimum lease payments payable from those disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

(18) Sale of Business Line
On March 1, 2014, the Corporation sold its merchant processing service business line to a third party. The sale resulted in a net gain of $6.3 million; after-tax $4.0 million, or 24 cents per diluted share. In connection with the sale, Washington Trust incurred divestiture related costs of $355 thousand; after-tax $227 thousand, or 1 cent per diluted share, which were also recognized in the first quarter of 2014. The net proceeds received from the sale totaled $7.2 million, including $900 thousand of deferred revenue that can be earned over a 5-year period by providing business referrals to the buyer. As of June 30, 2015, $648 thousand of deferred revenue remained to be earned under this arrangement.

(19) Subsequent Event
On August 1, 2015, the Corporation completed the acquisition of Halsey Associates, Inc. ("Halsey"), a registered investment adviser firm located in New Haven, CT. Halsey specializes in providing investment counseling services to high-net worth families, corporations, foundations and endowment clients. The cost to acquire Halsey included approximately $1.7 million in cash, $5.4 million in the form of 136,543 shares of Washington Trust common stock and approximately $3.0 million for the estimated amount of future earn-outs to be paid, based on the future revenue growth of the acquired business during the 5 year period following the acquisition.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
The following discussion should be read in conjunction with the Corporation's consolidated financial statements and notes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2014, and in conjunction with the condensed unaudited consolidated financial statements and notes thereto included in Item 1 of this report. Operating results for the three and six months ended June 30, 2015 are not necessarily indicative of the results for the full-year ended December 31, 2015 or any future period.

Forward-Looking Statements
This report contains statements that are "forward-looking statements." We may also make forward-looking statements in other documents we file with the SEC, in our annual reports to shareholders, in press releases and other written materials, and in oral statements made by our officers, directors or employees. You can identify forward-looking statements by the use of the words "believe," "expect," "anticipate," "intend," "estimate," "assume," "outlook," "will," "should other expressions that predict or indicate future events and trends and which do not relate to historical matters. You should not rely on forward-looking statements, because they involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. These risks, uncertainties and other factors may cause our actual results, performance or achievements to be materially different than the anticipated future results, performance or achievements expressed or implied by the forward-looking statements.

Some of the factors that might cause these differences include the following: weakness in national, regional or international economic conditions or conditions affecting the banking or financial services industries or financial capital markets; volatility in national and international financial markets; additional government intervention in the U.S. financial system; reductions in net interest income resulting from interest rate volatility as well as changes in the balance and mix of loans and deposits; reductions in the market value of wealth management assets under administration; changes in the value of securities and other assets; reductions in loan demand; changes in loan collectibility, default and charge-off rates; changes in the size and nature of the our competition; changes in legislation or regulation and accounting principles, policies and guidelines; and changes in the assumptions used in making such forward-looking statements. In addition, the factors described under "Risk Factors" in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2014, as updated by our Quarterly Reports on Form 10-Q and other filings submitted to the SEC, may result in these differences. You should carefully review all of these factors and you should be aware that there may be other factors that could cause these differences. These forward-looking statements were based on information, plans and estimates at the date of this report, and we assume no obligation to update any forward-looking statements to reflect changes in underlying assumptions or factors, new information, future events or other changes.

Critical Accounting Policies and Estimates
Accounting policies involving significant judgments, estimates and assumptions by management, which have, or could have, a material impact on the carrying value of certain assets and impact income are considered critical accounting policies. The Corporation considers the following to be its critical accounting policies: allowance for loan losses, review of goodwill for impairment and the assessment of investment securities for impairment. There have been no significant changes in the Corporation's critical accounting policies and estimates from those disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

Recently Issued Accounting Pronouncements
See Note 2 to the Unaudited Consolidated Financial Statements for details of recently issued accounting pronouncements and their expected impact on the Corporation's financial statements.

Overview
Washington Trust offers a comprehensive product line of banking and financial services to individuals and businesses, including commercial, residential and consumer lending, retail and commercial deposit products, and wealth management services through its offices in Rhode Island, eastern Massachusetts and Connecticut; its ATM networks;

and its Internet website at www.washtrust.com.

Our largest source of operating income is net interest income, the difference between interest earned on loans and securities and interest paid on deposits and borrowings. In addition, we generate noninterest income from a number of sources, including wealth management services, loan sales and commissions on loans originated for others and deposit services. Our principal noninterest expenses include salaries and employee benefits, occupancy and facility-related costs, technology and other administrative expenses.

Our financial results are affected by interest rate fluctuations, changes in economic and market conditions, competitive conditions within our market area and changes in legislation, regulation and/or accounting principles. While the regional economic climate has been improving in recent quarters, adverse changes in future economic growth, consumer confidence, credit availability and corporate earnings could impact our financial results. Management believes that overall credit quality has been stable to improving, generally in line with the pace of recovery in regional economic conditions.

We continued to leverage our strong, statewide brand to build market share in Rhode Island and bring select business lines to new markets with high-growth potential while remaining steadfast in our commitment to provide superior service. We plan to open a new full-service branch in Providence, Rhode Island, in the fourth quarter of 2015 and another full-service branch in Coventry, Rhode Island, in 2016.

Acquisition of Halsey Associates, Inc.
In June 2015, we signed a definitive agreement to acquire Halsey, a registered investment adviser firm located in New Haven, Connecticut. Halsey specializes in providing investment counseling services to high-net worth families, corporations, foundations and endowment clients. Halsey has approximately $850 million of assets under management and revenues of approximately $4.0 million on an annualized basis. We completed the acquisition of Halsey on August 1, 2015. The cost to acquire Halsey included approximately $1.7 million in cash, $5.4 million in the form of 136,543 shares of Washington Trust common stock and approximately $3.0 million for the estimated present value of future earn-outs to be paid, based on the future revenue growth of the acquired business during the 5-year period following the acquisition. The acquisition is expected to result in additions to goodwill and identifiable intangible assets of approximately $7.2 million and $6.4 million, respectively. Acquisition-related expenses of $433 thousand were recognized in the three months ended June 30, 2015 and additional acquisition-related expenses of approximately $600 thousand are expected to the recognized in the third quarter. Following the recognition of these acquisition-related expenses, the transaction is expected to be modestly accretive to earnings per share, including the recognition of intangible asset amortization, commencing in the latter part of 2015.

Composition of Earnings
Net income for the second quarter of 2015 amounted to $11.5 million, or $0.68 per diluted share, up from $9.8 million, or $0.58 per diluted share, reported for the second quarter of 2014. The returns on average equity and average assets for the second quarter of 2015 were 12.88% and 1.27%, respectively, compared to 11.52% and 1.22%, respectively, for the same quarter in 2014.

For the six months ended June 30, 2015, net income totaled $22.5 million, or $1.32 per diluted share, up from $19.1 million, or $1.13 per diluted share, reported for the same period in 2014. The returns on average equity and average assets for the six months ended June 30, 2015 were 12.71% and 1.25%, respectively, compared to 11.31% and 1.20%, respectively, for the same period in 2014.

2014 results included the following transactions, which reduced net income for the six months ended June 30, 2014 by $245 thousand, or $0.01 per diluted share:

- On March 1, 2014, the Corporation sold its merchant processing service business line to a third party. The sale resulted in a gain of $6.3 million, after-tax $4.0 million, or $0.24 per diluted share.
- In connection with this sale, the Corporation incurred divestiture related costs of $355 thousand, after-tax $227 thousand, or $0.01 per diluted share. The majority of the divestiture costs were classified as salaries and employee benefit costs.
- Washington Trust also prepaid FHLBB advances totaling $99.3 million, resulting in debt prepayment penalty expense of $6.3 million, after-tax $4.0 million, or $0.24 per diluted share.

Excluding the above mentioned transactions, as well as the merchant processing fee revenue and expenses recognized prior to the consummation of the business line sale, increased profitability in 2015 as compared to 2014 reflected growth in net interest income, a decrease in the provision for loan losses, higher wealth management revenues, strong mortgage banking revenues and increased net gains on interest rate swap contracts, which were partially offset by higher salaries and employee benefit costs.

Net interest income for the three and six months ended June 30, 2015 amounted to $26.0 million and $51.7 million, up by 6% and 7%, respectively, from the comparable periods in 2014, reflecting growth in average loan balances. The net interest margin (fully taxable equivalent net interest income as a percentage of average interest-earnings assets) was 3.15% and 3.16%, respectively, for the three and six months ended June 30, 2015, compared to 3.35% and 3.34%, respectively, for the same periods in 2014. The year over year decline in the net interest margin reflects lower yields on interest-earning assets as a result of the low interest rate environment.

The provision for loan losses for both the three and six months ended June 30, 2015 amounted to $100 thousand, down by $350 thousand and $650 thousand, respectively, from the same periods in 2014. The modest level of provision in 2015 reflects loan loss allocations commensurate with growth in loan portfolio balances, offset by reductions in other loan loss exposures in response to continued improvement in conditions affecting credit quality.

Wealth management revenues for the three and six months ended June 30, 2015 totaled $8.9 million and $17.3 million, respectively, up by 4% and 5%, respectively, from the same periods in 2014, due to an increase in asset-based wealth management revenues.

Net gains on loan sales and commissions on loans originated for others ("mortgage banking revenues") for the three and six months ended June 30, 2015 amounted to $2.7 million and $5.3 million, respectively, up by 61% and 81%, respectively, from the same periods in 2014, due to an increase in residential mortgage loan sales activity.

Salaries and employee benefit costs, the largest component of noninterest expenses, totaled $15.5 million and $31.0 million, respectively, for the three and six months ended June 30, 2015, up by 5% and 6%, respectively, from the same periods in 2014, largely due to increased staffing levels in our wealth management business line, as well as higher defined benefit pension costs and increased share-based compensation expense.

Results of Operations
Segment Reporting
Washington Trust manages its operations through two business segments, Commercial Banking and Wealth Management Services. Activity not related to the segments, such as investment securities portfolio, wholesale funding activities, net gain on sale of business line, income from bank-owned life insurance ("BOLI") and administrative expenses are not allocated to the operating segments and are considered Corporate. The Corporate unit also includes the residual impact of methodology allocations such as funds transfer pricing offsets. Methodologies used to allocate income and expenses to business lines are periodically reviewed and revised. See Note 14 to the Unaudited Consolidated Financial Statements for additional disclosure related to business segments.

The Commercial Banking segment reported net income of $8.2 million and $15.9 million, respectively, for the three and six months ended June 30, 2015, compared to $6.3 million and $12.8 million, respectively, for the same periods in 2014. Net interest income for this operating segment for the three and six months ended June 30, 2015, increased by $1.4 million and $2.3 million, respectively, from the same periods in 2014, primarily due to a favorable shift to lower-cost deposits. The loan loss provision charged to earnings amounted to $100 thousand for both the three and six months ended June 30, 2015, compared to $450 thousand and $750 thousand, respectively, for the same periods in 2014. The year over year decline in the provision for loan losses reflects continued improvement in conditions affecting credit quality. Noninterest income derived from the Commercial Banking segment totaled $5.6 million and $10.7 million, respectively, for the three and six months ended June 30, 2015, up by $1.7 million and $2.3 million, respectively, from the comparable periods in 2014. The increase in noninterest income was largely due to higher mortgage banking revenues and customer-related interest rate swap fee income, partially offset by a decrease in merchant processing fee revenue, due to the sale of this business line on March 1, 2014. The decrease in merchant processing fee revenue corresponded to a decline in merchant processing costs included in this operating segment's noninterest expenses. Commercial Banking noninterest expenses for the three and six months ended June 30, 2015 were up by $666 thousand and $786 thousand, respectively, from the same periods in 2014, including increases in net occupancy costs and outsourced services, which were partially offset by a decline in merchant processing costs.

The Wealth Management Services segment reported net income of $1.3 million and $2.7 million, respectively, for the three and six months ended June 30, 2015, compared to $1.8 million and $3.2 million, respectively, for the same periods in 2014. Noninterest income derived from the Wealth Management Services segment was $8.9 million and $17.3 million, respectively, for the three and six months ended June 30, 2015, up by $382 thousand and $752 thousand, respectively, compared to the same periods in 2014, commensurate with increases in Wealth Management assets under administration. Noninterest expenses for the Wealth Management Services segment totaled $6.8 million and $13.0 million, respectively, for the three and six months ended June 30, 2015, up by $1.0 million and $1.5 million, respectively, from the same periods in 2014. Included in noninterest expenses in the three and six months ended June 30, 2015 were acquisition related expenses of $433 thousand. Excluding the acquisition related expenses, noninterest expenses were up by $577 thousand and $1.1 million, respectively, from the three and six months ended June 30, 2014, reflecting increases in salaries and benefit costs and outsourced services.

Net income attributed to the Corporate unit amounted to $2.0 million and $3.9 million, respectively, for the three and six months ended June 30, 2015, compared to $1.8 million and $3.0 million, respectively, for the same periods in 2014. The Corporate unit's net interest income for the three and six months ended June 30, 2015 increased by $149 thousand and $1.1 million, respectively, from the comparable 2014 periods, largely due to a favorable change in net funds transfer pricing offsets with the Commercial Banking segment, partially offset by a decrease in investment income and a higher level of wholesale funding expense. Included in noninterest income for the Corporate unit for the three months ended June 30, 2015 was a $250 thousand settlement payment received for a trust preferred debt security previously held by the Corporation. Excluding the settlement payment, noninterest income for the second quarter of 2015 increased modestly, compared to the same quarter a year ago. For the six months ended June 30, 2015, noninterest income decreased by $5.9 million, compared to the same period in 2014, primarily due to the gain on the sale of the merchant processing services business line recognized in the first quarter of 2014. The Corporate unit's noninterest expenses for the three months ended June 30, 2015 increased by $175 thousand, compared to the same period a year ago. For the six months ended June 30, 2015, noninterest expenses decreased by $6.2 million from the same period in 2014, largely due to debt prepayment penalty expense recognized in the first quarter of 2014. See additional discussion regarding these noninterest income and expense items in the "Overview" section under the caption "Composition of Earnings."

Net Interest Income

Net interest income continues to be the primary source of our operating income. Net interest income is affected by the level of interest rates, changes in interest rates and changes in the amount and composition of interest-earning assets and interest-bearing liabilities. Included in interest income are loan prepayment fees and certain other fees, such as late charges. The following discussion presents net interest income on a fully taxable equivalent ("FTE") basis by adjusting income and yields on tax-exempt loans and securities to be comparable to taxable loans and securities. For more information, see the section entitled "Average Balances / Net Interest Margin - Fully Taxable Equivalent (FTE) Basis" below.

FTE net interest income for the three and six months ended June 30, 2015 amounted to $26.7 million and $53.1 million, respectively, up from $25.1 million and $49.5 million, respectively for the same periods in 2014. The net interest margin was 3.15% and 3.16%, respectively, for the three and six months ended June 30, 2015, compared to 3.35% and 3.34% for the same periods in 2014.

Average interest-earning assets for both the three and six months ended June 30, 2015 were up by 13% from the average balances for the same periods in 2014, due to loan growth. The yield on average interest-earning assets for the three and six months ended June 30, 2015 declined by 23 basis points and 24 basis points, respectively, from the comparable periods in 2014, reflecting the impact of the sustained low interest rate environment.

Total average loans for the three and six months ended June 30, 2015 increased by $407.9 million and $425.9 million, respectively, from the average balances for the comparable 2014 periods, due to growth in average commercial and residential real estate mortgage loan balances. The yield on total loans for the three and six months ended June 30, 2015 was 3.99% and 4.00%, respectively, down by 21 basis points and 23 basis points, respectively, from the same periods in 2014. The contribution of loan prepayment fees and other fees to the yield on total loans was 8 basis points and 2 basis points, respectively, for the three and six months ended June 30, 2015. Comparable amounts for the same periods in 2014 were 3 basis points and 4 basis points, respectively. Due to the combined effect of new loan growth and the runoff of higher yielding loan balances, interest rates on total interest-earning assets may continue to decline.

Total average securities for the three and six months ended June 30, 2015 decreased by $18.3 million and $27.5 million, respectively, from the average balances for the same periods a year earlier. The FTE rate of return on securities for the three and six months ended June 30, 2015 decreased by 63 basis points and 62 basis points, respectively, from the comparable periods in 2014, due to runoff of higher yielding securities combined with purchases of lower yielding securities.

Average interest-bearing liabilities for the three and six months ended June 30, 2015 increased by 14% and 15%, respectively, from the average balances for the same periods in 2014, largely due to increases in wholesale brokered time deposits and FHLBB advances. The cost of funds for the three and six months ended June 30, 2015 declined by 6 basis points and 9 basis points, respectively, from the comparable 2014 periods, largely due to a decline in the rate paid on FHLBB advances. See additional discussion under the caption “Sources of Funds” for additional information regarding funding transactions.

The average balance of FHLBB advances for the three and six months ended June 30, 2015 were up by $171.1 million and $153.0 million, respectively, compared to the average balances for the same periods in 2014. The average rate paid on such advances for the three and six months ended June 30, 2015 was 1.94% and 1.92%, respectively, compared to 3.20% and 3.29%, respectively, for the comparable periods in 2014.

Total average interest-bearing deposits for the three and six months ended June 30, 2015 increased by $175.5 million and $204.0 million, respectively, from the average balances for the same periods in 2014. This included increases of $121.3 million and $147.0 million, respectively, in average out-of-market wholesale brokered time certificates of deposit. The average rate paid on wholesale brokered time deposits for the three and six months ended June 30, 2015 increased by 23 basis points and 20 basis points, respectively, compared to the same periods in 2014.

Excluding the increase in wholesale brokered time deposits, average in-market interest-bearing deposits for the three and six months ended June 30, 2015 grew by $54.2 million and $56.9 million, respectively, from the same periods in 2014, with growth in lower-cost deposit categories, partially offset by a decrease in average in-market time deposit balances. The average rate paid on in-market interest-bearing deposits for both the three and six months ended June 30, 2015 decreased by 6 basis points compared to the same periods in 2014, due to lower rates on time deposits, offset, in part, by higher rates on money market deposits.

The average balance of noninterest-bearing demand deposits for the three and six months ended June 30, 2015 increased by $31.5 million and $23.8 million, respectively, compared to the average balances for the same periods in 2014.

Average Balances / Net Interest Margin - Fully Taxable Equivalent (FTE) Basis

The following tables present average balance and interest rate information. Tax-exempt income is converted to a FTE basis using the statutory federal income tax rate adjusted for applicable state income taxes net of the related federal tax benefit. For dividends on corporate stocks, the 70% federal dividends received deduction is also used in the calculation of tax equivalency. Unrealized gain (losses) on available for sale securities and fair value adjustments on mortgage loans held for sale are excluded from the average balance and yield calculations. Nonaccrual and renegotiated loans, as well as interest earned on these loans (to the extent recognized in the Consolidated Statements of Income) are included in amounts presented for loans.

Three months ended June 30,	2015			2014		
(Dollars in thousands)	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Assets:						
Commercial loans	$1,574,183	$15,930	4.06	$1,339,310	$14,509	4.35
Residential real estate loans, including mortgage loans held for sale	1,025,029	10,102	3.95	856,955	8,811	4.12
Consumer loans	338,809	3,183	3.77	333,881	3,171	3.81
Total loans	2,938,021	29,215	3.99	2,530,146	26,491	4.20
Cash, federal funds sold and short-term investments	63,858	29	0.18	59,507	28	0.19
FHLBB stock	37,730	164	1.74	37,730	138	1.47
Taxable debt securities	320,643	2,176	2.72	322,418	2,699	3.36
Nontaxable debt securities	40,886	627	6.15	57,422	847	5.92
Total securities	361,529	2,803	3.11	379,840	3,546	3.74
Total interest-earning assets	3,401,138	32,211	3.80	3,007,223	30,203	4.03
Noninterest-earning assets	221,577			207,426		
Total assets	$3,622,715			$3,214,649		
Liabilities and Shareholders’ Equity:						
Interest-bearing demand deposits	$38,129	$3	0.03	$9,067	$—	—
NOW accounts	363,434	53	0.06	311,948	47	0.06
Money market accounts	820,887	941	0.46	759,704	713	0.38
Savings accounts	298,286	50	0.07	291,671	45	0.06
Time deposits (in-market)	554,839	1,390	1.00	649,018	1,882	1.16
Wholesale brokered time deposits	285,844	911	1.28	164,540	433	1.06
FHLBB advances	391,152	1,891	1.94	220,088	1,758	3.20
Junior subordinated debentures	22,681	241	4.26	22,681	241	4.26
Other	116	2	6.92	162	4	9.90
Total interest-bearing liabilities	2,775,368	5,482	0.79	2,428,879	5,123	0.85
Demand deposits	441,355			409,851		
Other liabilities	48,627			35,684		
Shareholders’ equity	357,365			340,235		
Total liabilities and shareholders’ equity	$3,622,715			$3,214,649		
Net interest income		$26,729			$25,080	
Interest rate spread			3.01			3.18
Net interest margin			3.15			3.35

Interest income amounts presented in the preceding table include the following adjustments for taxable equivalency:

(Dollars in thousands)		
Three months ended June 30,	2015	2014
Commercial loans	$476	$322
Nontaxable debt securities	225	290
Total	$701	$612

Six months ended June 30,	2015			2014		
(Dollars in thousands)	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Assets:						
Commercial loans	$1,559,533	$31,242	4.04	$1,338,061	$29,109	4.39
Residential real estate loans, including mortgage loans held for sale	1,027,509	20,416	4.01	829,834	17,019	4.14
Consumer loans	337,578	6,351	3.79	330,854	6,268	3.82
Total loans	2,924,620	58,009	4.00	2,498,749	52,396	4.23
Cash, federal funds sold and short-term investments	57,492	54	0.19	60,869	63	0.21
FHLBB stock	37,730	329	1.76	37,730	280	1.50
Taxable debt securities	321,602	4,435	2.78	333,154	5,641	3.41
Nontaxable debt securities	42,762	1,291	6.09	58,683	1,731	5.95
Total securities	364,364	5,726	3.17	391,837	7,372	3.79
Total interest-earning assets	3,384,206	64,118	3.82	2,989,185	60,111	4.06
Noninterest-earning assets	221,686			205,391		
Total assets	$3,605,892			$3,194,576		
Liabilities and Shareholders’ Equity:						
Interest-bearing demand deposits	$37,991	$11	0.06	$9,912	$—	—
NOW accounts	346,605	100	0.06	308,096	94	0.06
Money market accounts	810,519	1,825	0.45	722,629	1,322	0.37
Savings accounts	296,117	96	0.07	292,237	90	0.06
Time deposits (in-market)	560,917	2,859	1.03	662,354	3,813	1.16
Wholesale brokered time deposits	290,230	1,846	1.28	143,199	770	1.08
FHLBB advances	397,925	3,793	1.92	244,900	3,999	3.29
Junior subordinated debentures	22,681	482	4.29	22,681	482	4.29
Other	122	5	8.26	168	7	8.40
Total interest-bearing liabilities	2,763,107	11,017	0.80	2,406,176	10,577	0.89
Demand deposits	440,136			416,377		
Other liabilities	48,342			34,377		
Shareholders’ equity	354,307			337,646		
Total liabilities and shareholders’ equity	$3,605,892			$3,194,576		
Net interest income		$53,101			$49,534	
Interest rate spread			3.02			3.17
Net interest margin			3.16			3.34

Interest income amounts presented in the preceding table include the following adjustments for taxable equivalency:
(Dollars in thousands)

Six months ended June 30,	2015	2014
Commercial loans	$917	$638
Nontaxable debt securities	454	592
Total	$1,371	$1,230

Volume / Rate Analysis - Interest Income and Expense (Fully Taxable Equivalent Basis)
The following table presents certain information on a FTE basis regarding changes in our interest income and interest expense for the period indicated. The net change attributable to both volume and rate has been allocated proportionately.

(Dollars in thousands)	Three months June 30, 2015 vs. 2014 Increase (Decrease) Due to			Six months June 30, 2015 vs. 2014 Increase (Decrease) Due to		
	Volume	Rate	Net Change	Volume	Rate	Net Change
Interest on Interest-Earning Assets:						
Commercial loans	$2,433	($1,012)	$1,421	$4,574	($2,441)	$2,133
Residential real estate loans, including mortgage loans held for sale	1,667	(376)	1,291	3,947	(550)	3,397
Consumer loans	46	(34)	12	131	(48)	83
Cash, federal funds sold and other short-term investments	2	(1)	1	(3)	(6)	(9)
FHLBB stock	—	26	26	—	49	49
Taxable debt securities	(15)	(508)	(523)	(191)	(1,015)	(1,206)
Nontaxable debt securities	(252)	32	(220)	(480)	40	(440)
Total interest income	3,881	(1,873)	2,008	7,978	(3,971)	4,007
Interest on Interest-Bearing Liabilities:						
Interest-bearing demand deposits	—	3	3	—	11	11
NOW accounts	6	—	6	6	—	6
Money market accounts	63	165	228	181	322	503
Savings accounts	1	4	5	—	6	6
Time deposits (in-market)	(252)	(240)	(492)	(551)	(403)	(954)
Wholesale brokered time deposits	373	105	478	912	164	1,076
FHLBB advances	1,006	(873)	133	1,873	(2,079)	(206)
Junior subordinated debentures	—	—	—	—	—	—
Other	(1)	(1)	(2)	(2)	—	(2)
Total interest expense	1,196	(837)	359	2,419	(1,979)	440
Net interest income	$2,685	($1,036)	$1,649	$5,559	($1,992)	$3,567

Provision and Allowance for Loan Losses
The provision for loan losses is based on management’s periodic assessment of the adequacy of the allowance for loan losses which, in turn, is based on such interrelated factors as the composition of the loan portfolio and its inherent risk characteristics; the level of nonperforming loans and net charge-offs, both current and historic; local economic and credit conditions; the direction of real estate values; and regulatory guidelines. The provision for loan losses is charged against earnings in order to maintain an allowance for loan losses that reflects management’s best estimate of probable losses inherent in the loan portfolio at the balance sheet date.

The provision for loan losses for both the three and six months ended June 30, 2015 amounted to $100 thousand, reflecting loan loss allocations commensurate with growth in loan portfolio balances, offset by reductions in other loan loss exposures in response to continued improvement in conditions affecting credit quality. In addition, the Corporation has experienced net reductions in nonaccrual loans in 8 of the last 9 quarters. The provision for loan losses for the three and six months ended June 30, 2014 amounted to $450 thousand and $750 thousand, respectively. Net charge-offs for the three and six months ended June 30, 2015 totaled $323 thousand and $536 thousand, respectively, compared to $224 thousand and $1.4 million, respectively, for the same periods in 2014. Year-to-date 2014 charge-offs included an $853 thousand charge-off recognized in the first quarter on one commercial mortgage relationship.

The allowance for loan losses was $27.6 million, or 0.94% of total loans, at June 30, 2015, compared to $28.0 million, or 0.98% of total loans, at December 31, 2014. See additional discussion under the caption “Asset Quality” below for further information on the Allowance for Loan Losses.

Noninterest Income

Noninterest income is an important source of revenue for Washington Trust. The principal categories of noninterest income are shown in the following table:

(Dollars in thousands)	Three months				Six months			
			Change				Change	
Periods ended June 30,	2015	2014	$	%	2015	2014	$	%
Noninterest income:								
Wealth management revenues	$8,912	$8,530	$382	4 %	$17,347	$16,595	$752	5 %
Merchant processing fees	—	—	—	—	—	1,291	(1,291)	(100)
Net gains on loan sales and commissions on loans originated for others	2,748	1,707	1,041	61	5,333	2,946	2,387	81
Service charges on deposit accounts	973	824	149	18	1,908	1,578	330	21
Card interchange fees	826	779	47	6	1,540	1,460	80	5
Income from bank-owned life insurance	492	441	51	12	982	886	96	11
Net gains on interest rate swap contracts	717	(37)	754	2,038	1,362	223	1,139	511
Equity in earnings (losses) of unconsolidated subsidiaries	(69)	(107)	38	36	(155)	(150)	(5)	(3)
Net gain on sale of business line	—	—	—	—	—	6,265	(6,265)	(100)
Other income	662	677	(15)	(2)	964	1,090	(126)	(12)
Total noninterest income	$15,261	$12,814	$2,447	19 %	$29,281	$32,184	($2,903)	(9)%

Noninterest Income Analysis

Revenue from wealth management services is our largest source of noninterest income. A substantial portion of wealth management revenues is largely dependent on the value of wealth management assets under administration and is closely tied to the performance of the financial markets. This portion of wealth management revenues is referred to as “asset-based” and includes trust and investment management fees and mutual fund fees. Wealth management revenues also include “transaction based” revenues, such as financial planning, commissions and other service fees that are not primarily derived from the value of assets.

The categories of wealth management revenues are shown in the following table:

(Dollars in thousands)	Three months				Six months			
			Change				Change	
Periods ended June 30,	2015	2014	$	%	2015	2014	$	%
Wealth management revenues:								
Trust and investment management fees	$7,238	$6,828	$410	6 %	$14,380	$13,513	$867	6 %
Mutual fund fees	1,032	1,086	(54)	(5)	2,068	2,167	(99)	(5)
Asset-based revenues	8,270	7,914	356	4	16,448	15,680	768	5
Transaction-based revenues	642	616	26	4	899	915	(16)	(2)
Total wealth management revenues	$8,912	$8,530	$382	4 %	$17,347	$16,595	$752	5 %

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The following table presents the changes in wealth management assets under administration:

(Dollars in thousands)	Three months		Six months	
Periods ended June 30,	2015	2014	2015	2014
Wealth management assets under administration:				
Balance at the beginning of period	$5,159,663	$4,806,381	$5,069,966	$4,781,958
Net investment appreciation & income	(13,932)	131,269	66,940	175,604
Net client cash flows	65,817	72,938	74,642	53,026
Balance at the end of period	$5,211,548	$5,010,588	$5,211,548	$5,010,588

Wealth management revenues for the three and six months ended June 30, 2015 were $8.9 million and $17.3 million, respectively, up by 4% and 5%, respectively, from the same periods in 2014, due to an increase in asset-based revenues. Wealth management assets under administration totaled $5.2 billion at June 30, 2015, up by $141.6 million, or 3%, from December 31, 2014, and up by $201.0 million, or 4%, from a year-ago.

As disclosed in the Overview section under the caption “Composition of Earnings,” the Corporation sold its merchant processing services business line on March 1, 2014, resulting in a net gain on sale of business line of $6.3 million. Prior to the consummation of this business line sale, merchant processing fee revenues of $1.3 million were recognized in the first quarter of 2014. See discussion below regarding corresponding merchant processing costs under the caption “Noninterest Expenses.”

Mortgage banking revenues are dependent on mortgage origination volume and are sensitive to interest rates and the condition of housing markets. Mortgage banking revenues totaled $2.7 million and $5.3 million, respectively, for the three and six months ended June 30, 2015, up by 61% and 81%, respectively, compared to the same periods in 2014. The year over year increase reflected higher mortgage loan origination and sales activity, as well as management’s efforts to increase the amount of mortgage loans originated for sale as a percentage of total mortgage loan originations. Residential mortgages sold to the secondary market, including brokered loans, totaled $143.2 million and $271.1 million, respectively, for the three and six months ended June 30, 2015. Comparable amounts for the same periods in 2014 were $77.0 million and $134.0 million, respectively.

Net gains on interest rate swap contracts for the three and six months ended June 30, 2015 increased by $754 thousand and $1.1 million, respectively, from the same periods in 2014, largely due to increased commercial loan borrower demand for these transactions.

For the three and six months ended June 30, 2015, other income amounted to $662 thousand and $964 thousand, respectively. This included a settlement payment of $250 thousand received in the second quarter for a trust preferred debt security previously held by Washington Trust. Excluding the settlement payment, other income decreased by $265 thousand and $376 thousand, respectively, from the comparable 2014 periods, reflecting increased amortization of loan servicing rights (offset to loan servicing fee income) due to payoffs of serviced residential mortgage loans.

Noninterest Expense

The following table presents noninterest expense comparisons:

(Dollars in thousands)	Three months				Six months			
			Change				Change	
Periods ended June 30,	2015	2014	$	%	2015	2014	$	%
Noninterest expenses:								
Salaries and employee benefits	$15,506	$14,771	$735	5 %	$31,000	$29,329	$1,671	6 %
Net occupancy	1,669	1,475	194	13	3,555	3,115	440	14
Equipment	1,376	1,235	141	11	2,716	2,471	245	10
Merchant processing costs	—	—	—	—	—	1,050	(1,050)	(100)
Outsourced services	1,277	1,015	262	26	2,524	2,059	465	23
Legal, audit and professional fees	610	598	12	2	1,286	1,216	70	6
FDIC deposit insurance costs	436	413	23	6	909	853	56	7
Advertising and promotion	578	540	38	7	845	772	73	9
Amortization of intangibles	156	164	(8)	(5)	311	328	(17)	(5)
Debt prepayment penalties	—	—	—	—	—	6,294	(6,294)	(100)
Other	2,691	2,237	454	20	4,684	4,253	431	10
Total noninterest expense	$24,299	$22,448	$1,851	8 %	$47,830	$51,740	($3,910)	(8)%

Noninterest Expense Analysis

For the three and six months ended June 30, 2015, salaries and employee benefit costs totaled $15.5 million and $31.0 million, respectively, up by 5% and 6%, respectively, compared to the same periods in 2014. Excluding $291 thousand of divestiture costs recognized in the first quarter of 2014, salaries and employee benefit costs for both the three and six months ended June 30, 2015 increased by 7% from the comparable periods in 2014. The year over year increase was largely due to increased staffing levels in our wealth management business line, higher defined benefit pension costs as a result of a lower discount rate in 2015 compared to 2014 and increased share-based compensation expense.

Net occupancy costs for the three and six months ended June 30, 2015 increased by $194 thousand and $440 thousand, respectively, up by 13% and 14%, respectively, from the comparable 2014 periods, including increased rental expense and other occupancy costs associated with a de novo branch that opened in the first quarter of 2015.

As disclosed in the Overview section under the caption “Composition of Earnings,” the Corporation sold its merchant processing services business line on March 1, 2014. Prior to the consummation of this business line sale, merchant processing costs of $1.1 million were recognized in the in the first quarter of 2014. See the discussion above regarding corresponding merchant processing fees under the caption “Noninterest Income.”

Outsourced services for the three and six months ended June 30, 2015 increased by $262 thousand and $465 thousand, respectively, up by 26% and 23%, respectively, from the same periods in 2014, reflecting an increase in services utilized in our wealth management business and due to increased volume and execution costs associated with customer-related interest rate swap transactions.

The prepayment of FHLBB advances in the first quarter of 2014 resulted in debt prepayment penalty expense of $6.3 million. See additional discussion regarding the prepayments in the “Overview” section above under the caption “Composition of Earnings.” There was no such debt prepayment penalty expense in the first quarter of 2015.

Other noninterest expenses for the three and six months ended June 30, 2015 increased by $454 thousand and $431 thousand, respectively, up by 20% and 10%, respectively, from the same periods in 2014, due to $433 thousand of acquisition related expenses incurred in the second quarter of 2015. See additional discussion regarding the acquisition in the Overview section.

Income Taxes

Income tax expense amounted to $5.4 million and $10.6 million, respectively, for the three and six months ended June 30, 2015, compared to $4.6 million and $8.9 million, respectively, for the same periods in 2014. The Corporation's effective tax rate was

31.9% for both the three and six months ended June 30, 2015, consistent with the effective tax rates for the same 2014 periods. The effective tax rates differed from the federal rate of 35% due largely to the benefits of tax-exempt income, income from BOLI and federal tax credits.

Financial Condition

Summary

Total assets amounted to $3.6 billion at June 30, 2015, up by $57.6 million from the end of 2014, largely due to net loan growth.

Nonperforming assets as a percent of total assets amounted to 0.45% at June 30, 2015, down by 3 basis points from the end of 2014. Management believes the overall credit quality has been stable to improving, generally in line with the pace of recovery in regional economic conditions.

Deposits totaled $2.7 billion at June 30, 2015, down by $15.7 million, or 1%, from the end of 2014, including a decrease of $14.5 million of out-of-market wholesale brokered time certificates of deposit. Excluding these wholesale brokered time deposits, in-market deposits decreased by $1.2 million. FHLBB advances amounted to $471.3 million as of June 30, 2015, up by $65.0 million, or 16%, from December 31, 2014.

Shareholders’ equity totaled $359.2 million at June 30, 2015, up by $12.9 million from the balance at the end of 2014. Capital levels continue to exceed the regulatory minimum levels to be considered well-capitalized, with a total risk-based capital ratio of 12.78% at June 30, 2015, compared to 12.56% at December 31, 2014. See Note 9 to the Unaudited Consolidated Financial Statements for additional discussion on regulatory capital requirements.

Securities

Washington Trust’s securities portfolio is managed to generate interest income, to implement interest rate risk management strategies, and to provide a readily available source of liquidity for balance sheet management. Securities are designated as either available for sale, held to maturity or trading at the time of purchase. The Corporation does not currently maintain a portfolio of trading securities. Securities available for sale may be sold in response to changes in market conditions, prepayment risk, rate fluctuations, liquidity, or capital requirements. Securities available for sale are reported at fair value, with any unrealized gains and losses excluded from earnings and reported as a separate component of shareholders’ equity, net of tax, until realized. Securities held to maturity are reported at amortized cost.

Determination of Fair Value

The Corporation uses an independent pricing service to obtain quoted prices. The prices provided by the independent pricing service are generally based on observable market data in active markets. The determination of whether markets are active or inactive is based upon the level of trading activity for a particular security class. The Corporation reviews the independent pricing service’s documentation to gain an understanding of the appropriateness of the pricing methodologies. The Corporation also reviews the prices provided by the independent pricing service for reasonableness based upon current trading levels for similar securities. If the prices appear unusual, they are re-examined and the value is either confirmed or revised. In addition, the Corporation periodically performs independent price tests of securities to ensure proper valuation and to verify our understanding of how securities are priced. As of June 30, 2015 and December 31, 2014, the Corporation did not make any adjustments to the prices provided by the pricing service.

Our fair value measurements generally utilize Level 2 inputs, representing quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, and model-derived valuations in which all significant input assumptions are observable in active markets.

See Notes 4 and 11 to the Unaudited Consolidated Financial Statements for additional information regarding the determination of fair value of investment securities.

Securities Portfolio

The carrying amounts of securities held are as follows:

(Dollars in thousands)	June 30, 2015			December 31, 2014		
	Amount	%		Amount	%	
Securities Available for Sale:						
Obligations of U.S. government-sponsored enterprises	$61,254	17	%	$31,172	9	%
Mortgage-backed securities issued by U.S. government agencies and U.S. government-sponsored enterprises	216,620	61		245,366	68	
Obligations of states and political subdivisions	40,674	12		49,176	14	
Individual name issuer trust preferred debt securities	26,724	8		25,774	7	
Corporate bonds	6,106	2		6,174	2	
Total securities available for sale	$351,378	100	%	$357,662	100	%

(Dollars in thousands)	June 30, 2015			December 31, 2014		
	Amount	%		Amount	%	
Securities Held to Maturity:						
Mortgage-backed securities issued by U.S. government agencies and U.S. government-sponsored enterprises	$22,523	100	%	$25,222	100	%
Total securities held to maturity	$22,523	100	%	$25,222	100	%

As of June 30, 2015, the investment securities portfolio totaled $373.9 million, down by $9.0 million from the balance at December 31, 2014. See the Corporation's Consolidated Statement of Cash Flows for further information regarding investment securities.

At June 30, 2015 and December 31, 2014, the net unrealized gain position on securities available for sale and held to maturity amounted to $5.6 million and $7.4 million, respectively, and included gross unrealized losses of $4.3 million and $5.0 million, respectively. These gross unrealized losses were temporary in nature and concentrated in variable rate trust preferred securities issued by financial services companies.

Obligations of States and Political Subdivisions

The carrying amount of obligations of states and political subdivisions included in our securities portfolio at June 30, 2015 totaled $40.7 million. The following table presents obligations of states and political subdivisions by geographic location:

(Dollars in thousands)	Amortized	Unrealized	Unrealized	Fair
June 30, 2015	Cost	Gains	Losses	Value
New Jersey	$24,201	$701	$—	$24,902
New York	8,072	255	—	8,327
Pennsylvania	1,963	76	—	2,039
Illinois	1,901	30	—	1,931
Other	3,350	125	—	3,475
Total	$39,487	$1,187	$—	$40,674

The following table presents obligations of states and political subdivisions by category:

(Dollars in thousands) June 30, 2015	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
General obligations	$37,172	$1,100	$—	$38,272
Revenue obligations (1)	2,315	87	—	2,402
Total	$39,487	$1,187	$—	$40,674

(1) Includes water and sewer districts, tax revenue obligations and other.

Washington Trust owns trust preferred security holdings of 7 individual name issuers in the financial services industry. The following table presents information concerning these holdings, including credit ratings. The Corporation's Investment Policy contains rating standards that specifically reference ratings issued by Moody's and S&P.

Individual Name Issuer Trust Preferred Debt Securities

(Dollars in thousands)	June 30, 2015				Credit Ratings			
					June 30, 2015		Form 10-Q Filing Date	
Named Issuer (parent holding company)	(i)	Amortized Cost	Fair Value	Unrealized Net Loss	Moody's	S&P	Moody's	S&P
JPMorgan Chase & Co.	2	$9,772	$8,395	($1,377)	Baa2	BBB-	Baa2	BBB-
Bank of America Corporation	3	5,774	5,070	(704)	Ba1 (ii)	BB (ii)	Ba1 (ii)	BB+ (ii)
Wells Fargo & Company	2	5,148	4,578	(570)	A1/Baa1	BBB+/BBB	A1/Baa1	BBB+/BBB
SunTrust Banks, Inc.	1	4,175	3,602	(573)	Baa2	BB+ (ii)	Baa2	BB+ (ii)
Northern Trust Corporation	1	1,986	1,735	(251)	A3	BBB+	A3	BBB+
State Street Corporation	1	1,977	1,735	(242)	A3	BBB	A3	BBB
Huntington Bancshares Incorporated	1	1,940	1,609	(331)	Baa2	BB (ii)	Baa2	BB (ii)
Totals	11	$30,772	$26,724	($4,048)				

(i) Number of separate issuances, including issuances of acquired institutions.
(ii) Rating is below investment grade.

The Corporation's evaluation of the impairment status of individual name trust preferred securities includes various considerations in addition to the degree of impairment and the duration of impairment. We review the reported regulatory capital ratios of the issuer and, in all cases, the regulatory capital ratios were deemed to be in excess of the regulatory minimums. Credit ratings were also taken into consideration, including ratings in effect as of the reporting period date as well as credit rating changes between the reporting period date and the filing date of this report. We noted no additional downgrades to below investment grade between December 31, 2014 and the filing date of this report. Where available, credit ratings from multiple rating agencies are obtained and rating downgrades are specifically analyzed. Our review process for these credit-sensitive holdings also includes a periodic review of relevant financial information for each issuer, such as quarterly financial reports, press releases and analyst reports. This information is used to evaluate the current and prospective financial condition of the issuer in order to assess the issuer's ability to meet its debt obligations. Through the filing date of this report, each of the individual name issuer securities was current with respect to interest payments. Based on our evaluation of the facts and circumstances relating to each issuer, management concluded that all principal and interest payments for these individual name issuer trust preferred debt securities would be collected according to their contractual terms and it expects to recover the entire amortized cost basis of these securities. Furthermore, Washington Trust does not intend to sell these securities and it is not more-likely-than-not that Washington Trust will be required to sell these securities before recovery of their cost basis, which may be at maturity. Therefore, management does not consider these investments to be other-than-temporarily impaired at June 30, 2015.

Further deterioration in credit quality of the underlying issuers of the securities, further deterioration in the condition of the financial services industry, a continuation or worsening of the current economic environment, or additional declines in real estate values, amount other things, may further affect the fair value of these securities and increase the potential that certain unrealized losses may be designated as other-than-temporary in future periods, and the Corporation may incur write-downs.

Loans
Total loans amounted to $2.9 billion at June 30, 2015, up by $69.3 million, or 2%, from the end of 2014, largely due to growth in the commercial loan portfolio.

Commercial Loans
Commercial loans fall into two major categories, commercial real estate and commercial and industrial loans. Commercial real estate loans consist of commercial mortgages secured by real property where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing or permanent financing of the property. Commercial real estate loans also include construction loans made to businesses for land development or the on-site construction of industrial, commercial, or residential buildings. Commercial and industrial loans primarily provide working capital, equipment financing and financing for other business-related purposes. Commercial and industrial loans are frequently collateralized by equipment, inventory, accounts receivable, and/or general business assets. A significant portion of the Bank's commercial and industrial loans is also collateralized by real estate. Commercial and industrial loans also include tax exempt loans made to states and political subdivisions, as well as industrial development or revenue bonds issued through quasi-public corporations for the benefit of a private or non-profit entity where that entity rather than the governmental entity is obligated to pay the debt service.

Commercial Real Estate Loans
Commercial real estate loans amounted to $987.6 million at June 30, 2015, up by $64.0 million, or 7%, from $923.6 million at December 31, 2014. The growth in commercial real estate loans was in large part due to enhanced business cultivation efforts with new and existing borrowers, with an emphasis on larger loan balances to borrowers or groups of related borrowers. Included in the end of period commercial and real estate amounts were commercial construction loans of $111.0 million and $79.6 million, respectively.

Commercial real estate loans are secured by a variety of property types, with approximately 85% of the total at June 30, 2015 composed of office buildings, retail facilities, commercial mixed use, multi-family dwellings, lodging and industrial and warehouse properties.

The following table presents a geographic summary of commercial real estate loans, including commercial construction, by property location:

(Dollars in thousands)	June 30, 2015			December 31, 2014		
	Amount	% of Total		Amount	% of Total	
Rhode Island, Connecticut, Massachusetts	$915,622	93	%	$861,422	93	%
New York, New Jersey, Pennsylvania	58,379	6		53,625	6	
New Hampshire	13,577	1		8,523	1	
Total	$987,578	100	%	$923,570	100	%

Commercial and Industrial Loans
Commercial and industrial loans amounted to $596.0 million at June 30, 2015, down by $16.0 million, or 3%, from the balance at December 31, 2014. This portfolio includes loans to a variety of business types. Approximately 78% of the total is composed of owner occupied and other real estate, health care/social assistance, manufacturing, retail trade, accommodation and food services, public administration, entertainment and recreation, construction, professional, scientific and technical and wholesale trade businesses.

Residential Real Estate Loans
Residential real estate loans amounted to $1.0 billion at June 30, 2015, up by $15.8 million, or 2%, from the balance at December 31, 2014. Washington Trust originates residential real estate mortgages within our general market area of Southern New England for portfolio and for sale in the secondary market. In recent years, the mortgage origination

business has been expanded beyond our bank branch network, which is primarily located in Rhode Island, through the addition of residential mortgage lending offices in eastern Massachusetts and Connecticut. We also originate residential real estate mortgages for various investors in a broker capacity, including conventional mortgages and reverse mortgages. Total residential real estate loan originations for retention in portfolio were $119.8 million for the six months ended June 30, 2015, compared to $171.2 million for the six months ended June 30, 2014. Total residential real estate loan originations for sale to the secondary market, including loans originated in a broker capacity, were $263.4 million for the six months ended June 30, 2015, compared to $144.3 million for the six months ended June 30, 2014.

Loans are sold with servicing retained or released. Loans sold with the retention of servicing result in the capitalization of servicing rights, which are subsequently amortized over the estimated period of servicing. The net balance of capitalized servicing rights amounted to $3.1 million and $3.0 million, respectively, as of June 30, 2015 and December 31, 2014. The balance of residential mortgage loans serviced for others, which are not included in the Consolidated Balance Sheets, amounted to $414.8 million and $378.8 million, respectively, as of June 30, 2015 and December 31, 2014.

Included in residential real estate loans were purchased residential mortgage balances totaling $30.4 million and $32.8 million, respectively, as of June 30, 2015 and December 31, 2014. These loans were purchased from other financial institutions prior to March 2009.

The following is a geographic summary of residential real estate mortgages by property location:

(Dollars in thousands)	June 30, 2015			December 31, 2014		
	Amount	% of Total		Amount	% of Total	
Rhode Island, Connecticut, Massachusetts	$980,646	98.0	%	$965,452	98.1	%
New Hampshire	11,487	1.1		10,204	1.0	
New York, Virginia, New Jersey, Maryland, Pennsylvania	4,620	0.5		5,096	0.5	
Ohio	1,686	0.2		1,812	0.2	
Washington, Oregon	1,318	0.1		1,331	0.1	
Georgia	1,052	0.1		1,062	0.1	
Other	454	—		458	—	
Total	$1,001,263	100.0	%	$985,415	100.0	%

Consumer Loans

Consumer loans amounted to $343.8 million at June 30, 2015, up by $5.4 million, or 2%, from December 31, 2014. Our consumer portfolio is predominantly home equity lines and home equity loans, representing 86% of the total consumer portfolio at June 30, 2015. Consumer loans also include personal installment loans and loans to individuals secured by general aviation aircraft and automobiles.

Asset Quality

Nonperforming Assets

Nonperforming assets include nonaccrual loans, nonaccrual investment securities and property acquired through foreclosure or repossession.

The following table presents nonperforming assets and additional asset quality data:

(Dollars in thousands)	Jun 30, 2015	Dec 31, 2014
Nonaccrual loans:		
Commercial mortgages	$4,915	$5,315
Commercial construction & development	—	—
Commercial & industrial	1,039	1,969
Residential real estate mortgages	7,411	7,124
Consumer	1,766	1,537
Total nonaccrual loans	15,131	15,945
Nonaccrual investment securities	—	—
Property acquired through foreclosure or repossession, net	1,388	1,176
Total nonperforming assets	$16,519	$17,121
Nonperforming assets to total assets	0.45 %	0.48 %
Nonperforming loans to total loans	0.52 %	0.56 %
Total past due loans to total loans	0.82 %	0.63 %
Accruing loans 90 days or more past due	$—	$—

Nonperforming assets totaled $16.5 million, or 0.45% of total assets, at June 30, 2015, compared to $17.1 million, or 0.48% of total assets, at December 31, 2014. Property acquired through foreclosure or repossession amounted to $1.4 million at June 30, 2015 and consisted of 5 residential properties and 2 commercial properties. Nonaccrual loans totaled $15.1 million at June 30, 2015, down $814 thousand from the balance at December 31, 2014.

Nonaccrual Loans

During the six months ended June 30, 2015, the Corporation made no changes in its practices or policies concerning the placement of loans or investment securities into nonaccrual status. There were no significant commitments to lend additional funds to borrowers whose loans were on nonaccrual status at June 30, 2015.

The following table presents additional detail on nonaccrual loans:

(Dollars in thousands)	June 30, 2015				December 31, 2014			
	Days Past Due				Days Past Due			
	Over 90	Under 90	Total	% (1)	Over 90	Under 90	Total	% (1)
Commercial mortgages	$4,915	$—	$4,915	0.56 %	$5,315	$—	$5,315	0.63 %
Commercial construction & development	—	—	—	—	—	—	—	—
Commercial & industrial	638	401	1,039	0.17	181	1,788	1,969	0.32
Residential real estate mortgages	4,871	2,540	7,411	0.74	3,284	3,840	7,124	0.72
Consumer	647	1,119	1,766	0.51	897	640	1,537	0.45
Total nonaccrual loans	$11,071	$4,060	$15,131	0.52 %	$9,677	$6,268	$15,945	0.56 %

(1) Percentage of nonaccrual loans to the total loans outstanding within the respective category.

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Approximately 81% of total nonaccrual loans at June 30, 2015 consisted of commercial mortgages and residential real estate mortgage loans.

Nonaccrual commercial mortgage loans were $4.9 million at June 30, 2015, down by $400 thousand from the balance at the end of 2014. All of the nonaccrual commercial mortgage loans at June 30, 2015 and December 31, 2014 were located in Rhode Island and Connecticut. As of June 30, 2015, the largest nonaccrual relationship in the commercial mortgage category was comprised of one troubled debt restructured loan with a carrying value of $4.5 million, which was classified into nonaccrual status in the third quarter of 2014 because the borrower failed to perform in accordance with the terms of the restructuring. This loan is secured by commercial property and is collateral dependent. Based on the fair value of the underlying collateral, a $1.1 million loss allocation was deemed necessary at June 30, 2015.

Nonaccrual residential real estate mortgage loans increased modestly from the balance at the end of 2014. As of June 30, 2015, the $7.4 million balance of nonaccrual residential mortgage loans consisted of 24 loans, with $6.6 million located in Rhode Island, Connecticut and Massachusetts. Included in total nonaccrual residential mortgages at June 30, 2015 were 11 loans purchased for portfolio and serviced by others amounting to $3.0 million. Management monitors the collection efforts of its third party servicers as part of its assessment of the collectibility of nonperforming loans.

Past Due Loans

The following table presents past due loans by category:

(Dollars in thousands)	June 30, 2015			December 31, 2014		
	Amount	% (1)		Amount	% (1)	
Commercial mortgages	$4,929	0.56	%	$5,315	0.63	%
Commercial construction & development	—	—		—	—	
Commercial & industrial	5,518	0.93		3,519	0.58	
Residential real estate mortgages	10,904	1.09		7,048	0.72	
Consumer loans	2,678	0.78		2,196	0.65	
Total past due loans	$24,029	0.82	%	$18,078	0.63	%

(1) Percentage of past due loans to the total loans outstanding within the respective category.

As of June 30, 2015, total past due loans amounted to $24.0 million, or 0.82% of total loans, up from $18.1 million, or 0.63%, at December 31, 2014. The increase from the end of 2014 included a $1.4 million nonaccrual residential real estate mortgage and a $3.5 million well-secured commercial and industrial loan relationship.

Included in past due loans as of June 30, 2015 and December 31, 2014 were nonaccrual loans of $12.7 million, respectively. All loans 90 days or more past due at June 30, 2015 and December 31, 2014 were classified as nonaccrual.

Troubled Debt Restructurings

Loans are considered restructured in a troubled debt restructuring when the Corporation has granted concessions to a borrower due to the borrower's financial condition that it otherwise would not have considered. These concessions include modifications of the terms of the debt such as reduction of the stated interest rate other than normal market rate adjustments, extension of maturity dates, or reduction of principal balance or accrued interest. The decision to restructure a loan, versus aggressively enforcing the collection of the loan, may benefit the Corporation by increasing the ultimate probability of collection.

Restructured loans are classified as accruing or non-accruing based on management's assessment of the collectibility of the loan. Loans which are already on nonaccrual status at the time of the restructuring generally remain on nonaccrual status for approximately six months before management considers such loans for return to accruing status. Accruing restructured loans are placed into nonaccrual status if and when the borrower fails to comply with the restructured terms and management deems it unlikely that the borrower will return to a status of compliance in the near term.

Troubled debt restructurings are reported as such for at least one year from the date of the restructuring. In years after the restructuring, troubled debt restructured loans are removed from this classification if the restructuring did not involve a below market rate concession and the loan is not deemed to be impaired based on the terms specified in the restructuring agreement. As of June 30, 2015, there were no significant commitments to lend additional funds to borrowers whose loans had been restructured.

The following table sets forth information on troubled debt restructured loans as of the dates indicated. The amounts below consist of unpaid principal balance, net of charge-offs and unamortized deferred loan origination fees and costs. Accrued interest is not included in the carrying amounts set forth below. See Note 5 to the Unaudited Consolidated Financial Statements for additional information.

(Dollars in thousands)	Jun 30, 2015	Dec 31, 2014
Accruing troubled debt restructured loans:		
Commercial mortgages	$9,448	$9,676
Commercial & industrial	2,209	954
Residential real estate mortgages	679	1,252
Consumer	201	135
Accruing troubled debt restructured loans	12,537	12,017
Nonaccrual troubled debt restructured loans:		
Commercial mortgages	4,498	4,898
Commercial & industrial	381	1,193
Residential real estate mortgages	92	248
Consumer	33	—
Nonaccrual troubled debt restructured loans	5,004	6,339
Total troubled debt restructured loans	$17,541	$18,356

As of June 30, 2015, loans classified as troubled debt restructurings totaled $17.5 million, down by $815 thousand from the end of 2014.

As of June 30, 2015, 80% of the troubled debt restructured loans consisted of two relationships. The largest troubled debt restructured relationship at June 30, 2015 consisted of an accruing commercial mortgage relationship with a carrying value of $9.4 million, secured by mixed use properties. The restructuring took place in the second quarter of 2013 and included a modification of certain payment terms and a below-market rate concession for a temporary period. The second largest troubled debt restructured relationship consisted of a commercial mortgage with a carrying value of $4.5 million at June 30, 2015, secured by commercial property. The restructuring took place in the third quarter of 2013 and included a modification of certain payment terms and a below-market rate concession for a temporary period. In connection with this restructuring, a principal paydown of $1.2 million was provided by the borrower during the third quarter of 2013. This troubled debt restructuring loan was classified into nonaccrual status in the third quarter of 2014. See additional disclosure about this relationship above under the caption “Nonaccrual Loans.”

Potential Problem Loans

The Corporation classifies certain loans as “substandard,” “doubtful,” or “loss” based on criteria consistent with guidelines provided by banking regulators. Potential problem loans consist of classified accruing commercial loans that were less than 90 days past due at June 30, 2015 and other loans for which known information about possible credit problems of the related borrowers causes management to have doubts as to the ability of such borrowers to comply with the present loan repayment terms and which may result in disclosure of such loans as nonperforming at some time in the future. These loans are not included in the amounts of nonaccrual or restructured loans presented above. Management cannot predict the extent to which economic conditions or other factors may impact borrowers and the potential problem loans. Accordingly, there can be no assurance that other loans will not become 90 days or more past due, be placed on nonaccrual, become restructured, or require increased allowance coverage and provision for loan losses. The Corporation has identified approximately $1.6 million in potential problem loans at June 30, 2015, compared to $1.2 million at December 31, 2014. Potential problem loans are assessed for loss exposure using the methods described in Note 5 to the Unaudited Consolidated Financial Statements under the caption "Credit Quality Indicators."

Allowance for Loan Losses
Establishing an appropriate level of allowance for loan losses necessarily involves a high degree of judgment. The Corporation uses a methodology to systematically measure the amount of estimated loan loss exposure inherent in the loan portfolio for purposes of establishing a sufficient allowance for loan losses. See additional discussion regarding the allowance for loan losses, in Item 7 under the caption "Critical Accounting Policies and Estimates" of Washington Trust's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 and in Note 6 to the Unaudited Consolidated Financial Statements.

The allowance for loan losses is management's best estimate of probable loan losses inherent in the loan portfolio as of the balance sheet date. The allowance is increased by provisions charged to earnings and by recoveries of amounts previously charged off, and is reduced by charge-offs on loans. The status of nonaccrual loans, delinquent loans and performing loans were all taken into consideration in the assessment of the adequacy of the allowance for loans losses. In addition, the balance and trends of credit quality indicators, including the commercial loan categories of Pass, Special Mention and Classified, are integrated into the process used to determine the allocation of loss exposure. See Note 5 to the Unaudited Consolidated Financial Statements for additional information under the caption "Credit Quality Indicators." Management believes that the level of allowance for loan losses at June 30, 2015 is adequate and consistent with asset quality and delinquency indicators. Management will continue to assess the adequacy of the allowance for loan losses in accordance with its established policies.

The Bank's general practice is to identify problem credits early and recognize full or partial charge-offs as promptly as practicable when it is determined that the collection of loan principal is unlikely. The Bank recognizes full or partial charge-offs on collateral dependent impaired loans when the collateral is deemed to be insufficient to support the carrying value of the loan. The Bank does not recognize a recovery when an updated appraisal indicates a subsequent increase in value.

Appraisals are generally obtained with values determined on an "as is" basis from independent appraisal firms for real estate collateral dependent commercial loans in the process of collection or when warranted by other deterioration in the borrower's credit status. Updates to appraisals are generally obtained for troubled or nonaccrual loans or when management believes it is warranted. The Corporation has continued to maintain appropriate professional standards regarding the professional qualifications of appraisers and has an internal review process to monitor the quality of appraisals.

For residential mortgages and real estate collateral dependent consumer loans that are in the process of collection, valuations are obtained from independent appraisal firms with values determined on an "as is" basis.

The estimation of loan loss exposure inherent in the loan portfolio includes, among other procedures, (1) identification of loss allocations for individual loans deemed to be impaired, (2) application of loss allocation factors for non-impaired loans based on credit grade, historical loss experience, estimated loss emergence period and delinquency status, with adjustments for various exposures not adequately presented in historical loss experience, and (3) an unallocated allowance maintained for measurement imprecision associated with impaired and nonaccrual loans. We periodically reassess and revise the loss allocation factors used in the assignment of loss exposure to appropriately reflect our analysis of migrational loss experience. Revisions to loss allocation factors are not retroactively applied. We analyze historical loss experience in the various portfolios over periods deemed to be relevant to the inherent risk of loss in the respective portfolios and the related estimate of the loss emergence period as of the balance sheet date.

The following is a summary of impaired loans by measurement type:

(Dollars in thousands)	Jun 30, 2015	Dec 31, 2014
Collateral dependent impaired loans (1)	$18,829	$19,761
Impaired loans measured on discounted cash flow method (2)	2,680	2,258

Total impaired loans	$21,509	$22,019

(1) Net of partial charge-offs of $833 thousand and $530 thousand, respectively, at June 30, 2015 and December 31, 2014.

(2) Net of partial charge-offs of $154 thousand and $264 thousand, respectively, at June 30, 2015 and December 31, 2014.

Impaired loans consist of nonaccrual commercial loans, troubled debt restructured loans and other loans classified as impaired that are individually evaluated for impairment. The loss allocation on impaired loans amounted to $1.7 million and $1.6 million, respectively, at June 30, 2015 and December 31, 2014. Various loan loss allowance coverage ratios are affected by the timing and extent of charge-offs, particularly with respect to impaired collateral dependent loans. For such loans, the Bank generally recognizes a partial charge-off equal to the identified loss exposure; therefore, the remaining allocation of loss is minimal.

Other individual commercial loans not deemed to be impaired are evaluated using the internal rating system and the application of loss allocation factors. The loan rating system and the related loss allocation factors take into consideration parameters including the borrower's financial condition, the borrower's performance with respect to loan terms, the adequacy of collateral and the adequacy of guarantees. Portfolios of more homogeneous populations of loans including residential mortgages and consumer loans are analyzed as groups, with loss allocation factors assigned to each group, taking into consideration delinquency status. Loss allocation factors are also adjusted for various exposures not adequately presented in historical loss experience. See additional disclosure under the caption "Credit Quality Indicators" in Note 5 to the Unaudited Consolidated Financial Statements.

The following table presents additional detail on the Corporation's loan portfolio and associated allowance for loan losses:

(Dollars in thousands)	June 30, 2015				December 31, 2014			
	Loans	Related Allowance	Allowance / Loans		Loans	Related Allowance	Allowance / Loans	
Impaired loans individually evaluated for impairment	$21,509	$1,653	7.69	%	$22,019	$1,583	7.19	%
Loans collectively evaluated for impairment	2,907,075	23,658	0.81		2,837,257	24,049	0.85	
Unallocated	—	2,276	—		—	2,391	—	
Total	$2,928,584	$27,587	0.94	%	$2,859,276	$28,023	0.98	%

The provision for loans losses amounted to $100 thousand for both the three and six months ended June 30, 2015, reflecting continued improvement in conditions affecting credit quality, offset by loan loss allocations commensurate with growth in loan portfolio balances. The provision for loan losses for the same periods in 2014 amounted to $450 thousand and $750 thousand, respectively. Net charge-offs for the three and six months ended June 30, 2015 totaled $323 thousand and $536 thousand, respectively, compared to $224 thousand and $1.4 million, respectively, for the same periods in 2014. Year-to-date 2014 charge-offs included an $853 thousand charge-off recognized in the first quarter on one commercial mortgage relationship.

As of June 30, 2015, the allowance for loan losses was $27.6 million, or 0.94% of total loans, compared to $28.0 million, or 0.98% of total loans, at December 31, 2014.

The following table presents the allocation of the allowance for loan losses. The allocation below is neither indicative of the specific amounts or the loan categories in which future charge-offs may occur, nor is it an indicator of any future loss trends.

(Dollars in thousands)	June 30, 2015			December 31, 2014		
	Amount	% (1)		Amount	% (1)	
Commercial:						
Mortgages	$8,529	30	%	$8,202	30	%
Construction & development	1,684	4		1,300	3	
Commercial & industrial	7,010	20		7,987	21	
Residential real estate:						
Mortgage	5,296	33		5,228	33	
Homeowner construction	109	1		202	1	
Consumer	2,683	12		2,713	12	
Unallocated	2,276			2,391		

Balance at end of period	$27,587	100	%	$28,023	100	%

(1) Percentage of allocated allowance for loan losses to the total loans outstanding within the respective category.

Sources of Funds

Our sources of funds include deposits, brokered time certificates of deposit, FHLBB borrowings, other borrowings and proceeds from the sales, maturities and payments of loans and investment securities. Washington Trust uses funds to originate and purchase loans, purchase investment securities, conduct operations, expand the branch network and pay dividends to shareholders.

Management's preferred strategy for funding asset growth is to grow low-cost deposits, including demand deposits, NOW and savings accounts. Asset growth in excess of low-cost deposits is typically funded through higher-cost deposits (including certificates of deposit and money market accounts), brokered time certificates of deposit, FHLBB borrowings and securities portfolio cash flow.

Deposits

Washington Trust offers a wide variety of deposit products to consumer and business customers. Deposits provide an important source of funding for the Bank as well as an ongoing stream of fee revenue.

Washington Trust is a participant in the Insured Cash Sweep ("ICS") program, Demand Deposit Marketplace ("DDM") program, and the Certificate of Deposit Account Registry Service ("CDARS") program. Washington Trust uses these deposit sweep services to place customer funds into interest-bearing demand accounts, money market accounts, and/or time certificates of deposit issued by other participating banks. Customer funds are placed at one or more participating banks to ensure that each deposit customer is eligible for the full amount of FDIC insurance. As a program participant, we receive reciprocal amounts of deposits from other participating banks. ICS, DDM and CDARS deposits are considered to be brokered deposits for bank regulatory purposes. We consider these reciprocal deposit balances to be in-market deposits as distinguished from traditional out-of-market brokered deposits.

Total deposits amounted to $2.7 billion at June 30, 2015, down by $15.7 million, or 1%, from the balance at December 31, 2014. Included in deposits at June 30, 2015 were out-of-market brokered time certificates of deposit of $284.6 million, which were down by $14.5 million from the balance at December 31, 2014. Excluding out-of-market brokered time certificates of deposit, in-market deposits were down by $1.2 million from the balance at December 31, 2014.

Demand deposits totaled $457.8 million at June 30, 2015, down by $2.1 million, or 0.5%, from December 31, 2014. Included in demand deposits at June 30, 2015 and December 31, 2014 were DDM reciprocal demand deposits of $27.9 million and $33.4 million, respectively.

NOW account balances increased by $31.5 million, or 10%, from December 31, 2014 and totaled $357.9 million at June 30, 2015. Savings accounts totaled $300.1 million at June 30, 2015, up by $8.4 million, or 3%, from December 31, 2014.

Money market accounts totaled $789.3 million at June 30, 2015, down by $13.4 million, or 2%, from the balance at December 31, 2014. Included in total money market deposits at June 30, 2015 and December 31, 2014 were ICS reciprocal money market deposits of $225.3 million and $267.9 million, respectively.

Time deposits amounted to $834.0 million at June 30, 2015, down by $40.1 million, or 5%, from the balance at December 31, 2014. Included in time deposits at June 30, 2015 were out-of-market wholesale brokered time certificates of deposit of $284.6 million, which were down by $14.5 million from the balance at December 31, 2014, as noted above. Excluding out-of-market brokered certificates of deposits, in-market time deposits totaled $549.4 million at June 30, 2015, down by $25.6 million from December 31, 2014. Included in in-market time deposits were CDARS reciprocal time deposits of $86.6 million and $85.1 million, respectively, at June 30, 2015 and December 31, 2014.

Borrowings

The Corporation utilizes advances from the FHLBB as well as other borrowings as part of its overall funding strategy. FHLBB advances are used to meet short-term liquidity needs, to purchase securities and to originate and purchase loans. FHLBB advances amounted to $471.3 million at June 30, 2015, up by $65.0 million from the balance at the end of 2014.

In March 2014, FHLBB advances totaling $99.3 million that had a weighted average rate of 3.01% and a weighted average remaining term of thirty-six months were prepaid. Brokered time deposits of $80.0 million and existing on-balance sheet liquidity were utilized for the prepayment of these advances. The brokered time deposits had an initial weighted average cost of 0.93% and weighted average maturity of thirty-five months.

In February 2015, FHLBB advances totaling $69.2 million were modified to lower interest rates and the maturities of these advances were extended. Original maturity dates ranging from 2016 to 2018 were modified to 2018 to 2022. The original weighted average interest rate was 4.06% and was revised to 3.50%.

Liquidity and Capital Resources

Liquidity Management

Liquidity is the ability of a financial institution to meet maturing liability obligations and customer loan demand. Washington Trust's primary source of liquidity is deposits, which funded approximately 69% of total average assets in the six months ended June 30, 2015. While the generally preferred funding strategy is to attract and retain low cost deposits, the ability to do so is affected by competitive interest rates and terms in the marketplace. Other sources of funding include discretionary use of purchased liabilities (e.g., FHLBB term advances and brokered time certificates of deposit), cash flows from the Corporation's securities portfolios and loan repayments. Securities designated as available for sale may also be sold in response to short-term or long-term liquidity needs although management has no intention to do so at this time. For a more detailed discussion on Washington Trust's detailed liquidity funding policy and contingency funding plan, see additional information in Item 7 under the caption "Liquidity and Capital Resources" of Washington Trust's Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

The Asset/Liability Committee ("ALCO") establishes and monitors internal liquidity measures to manage liquidity exposure. Liquidity remained well within target ranges established by the ALCO during the six months ended June 30, 2015. Based on its assessment of the liquidity considerations described above, management believes the Corporation's sources of funding meets anticipated funding needs.

For the six months ended June 30, 2015, net cash provided by financing activities amounted to $39.1 million. Net cash flows from FHLBB advances were offset, in part, by deposit outflows and cash dividends paid. Net cash used in investing activities totaled $64.3 million for the six months ended June 30, 2015. The most significant elements of cash flow within investing activities were net outflows related to growth in the loan portfolio and purchases of available for sale debt securities, which were offset by net cash inflows from maturities, calls and principal repayments of debt securities. Net cash provided by operating activities amounted to $28.9 million for the six months ended June 30, 2015. Net income totaled $22.5 million in the first six months of 2015 and the most significant adjustments to reconcile net income to net cash provided by operating activities pertain to mortgage banking activities. See the Corporation's Consolidated Statements of Cash Flows for further information about sources and uses of cash.

Capital Resources

Total shareholders' equity amounted to $359.2 million at June 30, 2015, up by $12.9 million from December 31, 2014, including net income of $22.5 million and a reduction of $11.6 million for dividend declarations.

The ratio of total equity to total assets amounted to 9.86% at June 30, 2015 compared to a ratio of 9.65% at December 31, 2014. Book value per share at June 30, 2015 and December 31, 2014 amounted to $21.34 and $20.68, respectively.

The Bancorp and the Bank are subject to various regulatory capital requirements. As of June 30, 2015, the Bancorp and the Bank exceeded the regulatory minimum levels to be considered "well-capitalized."

See Note 9 to the Unaudited Consolidated Financial Statements for additional discussion of regulatory capital requirements.

Contractual Obligations and Commitments

The Corporation has entered into numerous contractual obligations and commitments. The following tables summarize our contractual cash obligations and other commitments at June 30, 2015:

(Dollars in thousands)	Payments Due by Period				
	Total	Less Than 1 Year (1)	1-3 Years	3-5 Years	After 5 Years
Contractual Obligations:					
FHLBB advances (2)	$471,321	$253,811	$90,206	$80,354	$46,950
Junior subordinated debentures	22,681	—	—	—	22,681
Operating lease obligations	38,844	2,908	5,509	4,152	26,275
Software licensing arrangements	2,283	1,980	288	15	—
Other borrowings	110	51	59	—	—
Total contractual obligations	$535,239	$258,750	$96,062	$84,521	$95,906

(1) Maturities or contractual obligations are considered by management in the administration of liquidity and are routinely refinanced in the ordinary course of business.

(2) All FHLBB advances are shown in the period corresponding to their scheduled maturity.

(Dollars in thousands)	Amount of Commitment Expiration – Per Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	After 5 Years
Other Commitments:					
Commercial loans	$347,236	$182,463	$60,386	$63,500	$40,887
Home equity lines	204,471	—	—	—	204,471
Other loans	45,258	40,813	2,854	1,591	—
Standby letters of credit	5,402	5,179	223	—	—
Forward loan commitments to:					
Originate loans	61,107	61,107	—	—	—
Sell loans	98,122	98,122	—	—	—
Customer related derivative contracts:					
Interest rate swaps with customers	231,205	—	50,213	49,001	131,991
Mirror swaps with counterparties	231,205	—	50,213	49,001	131,991
Risk participation-in agreement	7,174	—	—	—	7,174
Interest rate risk management contract:					
Interest rate swap	22,681	22,681	—	—	—
Total commitments	$1,253,861	$410,365	$163,889	$163,093	$516,514

Off-Balance Sheet Arrangements

For additional information on derivative financial instruments and financial instruments with off-balance sheet risk see Notes 10 and 17 to the Unaudited Consolidated Financial Statements.

Asset/Liability Management and Interest Rate Risk

Interest rate risk is the primary market risk category associated with the Corporation's operations. Interest rate risk is the risk of loss to future earnings due to changes in interest rates. The ALCO is responsible for establishing policy guidelines on liquidity and acceptable exposure to interest rate risk. Periodically, the ALCO reports on the status of liquidity and interest rate risk matters to the Bank's Board of Directors. The objective of the ALCO is to manage assets and funding sources to produce results that are consistent with Washington Trust's liquidity, capital adequacy, growth, risk and profitability goals.

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The ALCO manages the Corporation's interest rate risk using income simulation to measure interest rate risk inherent in the Corporation's on-balance sheet and off-balance sheet financial instruments at a given point in time by showing the effect of interest rate shifts on net interest income over a 12-month horizon, the 13- to 24-month horizon and a 60-month horizon. The simulations assume that the size and general composition of the Corporation's balance sheet remain static over the simulation horizons, with the exception of certain deposit mix shifts from low-cost core savings to higher-cost time deposits in selected interest rate scenarios. Additionally, the simulations take into account the specific repricing, maturity, call options, and prepayment characteristics of differing financial instruments that may vary under different interest rate scenarios. The characteristics of financial instrument classes are reviewed periodically by the ALCO to ensure their accuracy and consistency.

The ALCO reviews simulation results to determine whether the Corporation's exposure to a decline in net interest income remains within established tolerance levels over the simulation horizons and to develop appropriate strategies to manage this exposure. As of June 30, 2015 and December 31, 2014, net interest income simulations indicated that exposure to changing interest rates over the simulation horizons remained within tolerance levels established by the Corporation. The Corporation defines maximum unfavorable net interest income exposure to be a change of no more than 5% in net interest income over the first 12 months, no more than 10% over the second 12 months, and no more than 10% over the full 60-month simulation horizon. All changes are measured in comparison to the projected net interest income that would result from an "unchanged" rate scenario where both interest rates and the composition of the Corporation's balance sheet remain stable for a 60-month period. In addition to measuring the change in net interest income as compared to an unchanged interest rate scenario, the ALCO also measures the trend of both net interest income and net interest margin over a 60-month horizon to ensure the stability and adequacy of this source of earnings in different interest rate scenarios.

The ALCO regularly reviews a wide variety of interest rate shift scenario results to evaluate interest risk exposure, including scenarios showing the effect of steepening or flattening changes in the yield curve of up to 500 basis points as well as parallel changes in interest rates of up to 400 basis points. Because income simulations assume that the Corporation's balance sheet will remain static over the simulation horizon, the results do not reflect adjustments in strategy that the ALCO could implement in response to rate shifts.

The following table sets forth the estimated change in net interest income from an unchanged interest rate scenario over the periods indicated for parallel changes in market interest rates using the Corporation's on- and off-balance sheet financial instruments as of June 30, 2015 and December 31, 2014. Interest rates are assumed to shift by a parallel 100, 200 or 300 basis points upward or 100 basis points downward over a 12-month period, except for core savings deposits, which are assumed to shift by lesser amounts due to their relative historical insensitivity to market interest rate movements. Further, deposits are assumed to have certain minimum rate levels below which they will not fall. It should be noted that the rate scenarios shown do not necessarily reflect the ALCO's view of the "most likely" change in interest rates over the periods indicated.

	June 30, 2015		December 31, 2014	
	Months 1 - 12	Months 13 - 24	Months 1 - 12	Months 13 - 24
100 basis point rate decrease	(1.08)%	(3.97)%	(0.93)%	(3.43)%
100 basis point rate increase	1.40	1.70	1.15	0.87
200 basis point rate increase	3.89	5.39	3.37	3.66
300 basis point rate increase	6.11	7.52	5.67	6.30

The ALCO estimates that the negative exposure of net interest income to falling rates as compared to an unchanged rate scenario results from a more rapid decline in earning asset yields compared to rates paid on deposits. If market interest rates were to fall from their already low levels and remain lower for a sustained period, certain core savings and time deposit rates could decline more slowly and by a lesser amount than other market rates. Asset yields would likely decline more rapidly than deposit costs as current asset holdings mature or reprice, since cash flow from mortgage-related prepayments and redemption of callable securities would increase as market rates fall.

The positive exposure of net interest income to rising rates as compared to an unchanged rate scenario results from a more rapid projected relative rate of increase in asset yields than funding costs over the near term. For simulation purposes, deposit rate changes are anticipated to lag behind other market rates in both timing and magnitude. The ALCO's estimate of interest rate risk exposure to rising rate environments, including those involving changes to the shape of the yield curve, incorporates certain assumptions regarding the shift in deposit balances from low-cost core savings categories to higher-cost deposit categories, which has characterized a shift in funding mix during the past rising interest rate cycles.

While the ALCO reviews and updates simulation assumptions and also periodically back-tests the simulation results to ensure that the assumptions are reasonable and current, income simulation may not always prove to be an accurate indicator of interest rate risk or future net interest margin. Over time, the repricing, maturity and prepayment characteristics of financial instruments and the composition of the Corporation's balance sheet may change to a different degree than estimated. Simulation modeling assumes a static balance sheet, with the exception of certain modeled deposit mix shifts from low-cost core savings deposits to higher-cost time deposits in rising rate scenarios as noted above. Due to the current low level of market interest rates, the banking industry has experienced relatively strong growth in low-cost core deposits over the past several years. The ALCO recognizes that a portion of these increased levels of low-cost balances could shift into higher yielding alternatives in the future, particularly if interest rates rise and as confidence in financial markets strengthens, and has modeled increased amounts of deposit shifts out of these low-cost categories into higher-cost alternatives in the rising rate simulation scenarios presented above. Deposit balances may also be subject to possible outflow to non-bank alternatives in a rising rate environment, which may cause interest rate sensitivity to differ from the results as presented. Another significant simulation assumption is the sensitivity of core savings deposits to fluctuations in interest rates. Income simulation results assume that changes in both core savings deposit rates and balances are related to changes in short-term interest rates. The relationship between short-term interest rate changes and core deposit rate and balance changes may differ from the ALCO's estimates used in income simulation. It should be noted that the static balance sheet assumption does not necessarily reflect the Corporation's expectation for future balance sheet growth, which is a function of the business environment and customer behavior. Lastly, mortgage-backed securities and mortgage loans involve a level of risk that unforeseen changes in prepayment speeds may cause related cash flows to vary significantly in differing rate environments. Such changes could affect the level of reinvestment risk associated with cash flow from these instruments, as well as their market value. Changes in prepayment speeds could also increase or decrease the amortization of premium or accretion of discounts related to such instruments, thereby affecting interest income.

The Corporation also monitors the potential change in market value of its available for sale debt securities in changing interest rate environments. The purpose is to determine market value exposure that may not be captured by income simulation, but which might result in changes to the Corporation's capital position. Results are calculated using industry-standard analytical techniques and securities data.

The following table summarizes the potential change in market value of the Corporation's available for sale debt securities as of June 30, 2015 and December 31, 2014 resulting from immediate parallel rate shifts:
(Dollars in thousands)

Security Type	Down 100 Basis Points	Up 200 Basis Points
U.S. government sponsored enterprise securities (callable)	$359	($4,938)
Obligations of states and political subdivisions	418	(813)
Mortgage-backed securities issued by U.S. government agencies and U.S. government-sponsored enterprises	3,944	(15,287)
Trust preferred debt and other corporate debt securities	21	638
Total change in market value as of March 31, 2015	$4,742	($20,400)
Total change in market value as of December 31, 2014	$4,777	($20,218)

Item 3. Quantitative and Qualitative Disclosures About Market Risk
Information regarding quantitative and qualitative disclosures about market risk appears under Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations," under the caption "Asset/Liability Management and Interest Rate Risk."

Item 4. Controls and Procedures
Disclosure Controls and Procedures

As required by Rule 13a-15 under the Exchange Act, as amended (the “Exchange Act”), the Corporation carried out an evaluation under the supervision and with the participation of the Corporation’s management, including the Corporation’s principal executive officer and principal financial officer, of the Corporation’s disclosure controls and procedures as of the period ended June 30, 2015. Based upon that evaluation, the principal executive officer and principal financial officer concluded that the Corporation’s disclosure controls and procedures are effective and designed to ensure that information required to be disclosed by the

Corporation in the reports it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) accumulated and communicated to the Corporation's management including its Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosures. The Corporation will continue to review and document its disclosure controls and procedures and consider such changes in future evaluations of the effectiveness of such controls and procedures, as it deems appropriate.

Internal Control Over Financial Reporting
The Corporation's management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined by the Exchange Act Rule 13a-15(f). The Corporation's internal control system was designed to provide reasonable assurance to its management and the Board of Directors regarding the preparation and fair presentation of published financial statements. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. The Corporation's management assessed the effectiveness of its internal control over financial reporting as of the end of the period covered by this report.

There has been no change in our internal control over financial reporting during the period ended June 30, 2015 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission issued its Internal Control - Integrated Framework (the "2013 Framework"). While the 2013 Framework's internal control components (i.e., control environment, risk assessment, control activities, information and communication, and monitoring activities) are the same as those in the 1992 Framework, the new framework requires companies to assess whether 17 principles are present and functioning in determining whether their system of internal control is effective. The Corporation expects to complete the adoption the 2013 Framework during 2015.

PART II. Other Information

Item 1. Legal Proceedings
The Corporation is involved in various claims and legal proceedings arising out of the ordinary course of business. Management is of the opinion, based on its review with counsel of the development of such matters to date, that the ultimate disposition of such matters will not materially affect the consolidated financial position or results of operations of the Corporation.

Item 1A. Risk Factors
There have been no material changes in the risk factors described in Item IA to Part I of Washington Trust's Annual Report on Form 10-K for the year ended December 31, 2014.

Item 6. Exhibits
(a) Exhibits. The following exhibits are included as part of this Form 10-Q:

Exhibit Number	
10.1	Terms of Amended and Restated Change in Control with an executive officer, dated June 1, 2015 - Filed herewith. (1)
10.2	Sixth Amendment to The Washington Trust Company Nonqualified Deferred Compensation Plan as Amended and Restated – Filed herewith. (1)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 – Filed herewith.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 – Filed herewith.
32.1	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 – Furnished herewith. (2)
101	The following materials from Washington Trust Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2015 formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Shareholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) related notes to these financial statements - Filed herewith.

(1) Management contract or compensatory plan or arrangement.

(2) These certifications are not "filed" for purposes of Section 18 of the Exchange Act or incorporated by reference into any filing under the Securities Act or the Securities Exchange Act.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

		WASHINGTON TRUST BANCORP, INC. (Registrant)
Date: August 6, 2015	By:	/s/ Joseph J. MarcAurele Joseph J. MarcAurele Chairman and Chief Executive Officer (principal executive officer)
Date: August 6, 2015	By:	/s/ David V. Devault David V. Devault Vice Chair, Secretary and Chief Financial Officer (principal financial and accounting officer)

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