FIRST OF LONG ISLAND CORP
Form 10-K
March 15, 2017
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

____

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2016

OR

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

For the transition period from _____ to _____

Commission file number 001-32964

THE FIRST OF LONG ISLAND CORPORATION
(Exact Name Of Registrant As Specified In Its Charter)

New York (State or Other Jurisdiction	11-2672906 (I.R.S. Employer
of Incorporation or Organization)	Identification No.)
10 Glen Head Road, Glen Head, NY (Address of Principal Executive Offices)	11545 (Zip Code)

Registrant's telephone number, including area code (516) 671-4900

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $.10 par value per share	The NASDAQ Stock Market

Securities registered pursuant to Section 12(g) of the Act:

None
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes __ No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes __ No X

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 requirement for the past 90 days. Yes X No __

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes X No __

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 [ ]   Accelerated filer [X]

Non-accelerated filer [ ]   Smaller reporting company [ ]

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

The aggregate market value of the Corporation’s voting common stock held by nonaffiliates as of June 30, 2016, the last business day of the Corporation’s most recently completed second fiscal quarter, was $428,876,938. This value was computed by reference to the price at which the stock was last sold on June 30, 2016 and excludes $18,108,259 representing the market value of common stock beneficially owned by directors and executive officers of the registrant.

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

Class	Outstanding, March 1, 2017
Common Stock, $.10 par value	23,901,419

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant’s Proxy Statement for the Annual Meeting of Stockholders to be held April 19, 2017 are incorporated by reference into Part III.

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PART I

PART I

ITEM 1. BUSINESS

General

The First of Long Island Corporation (“Registrant”), a one-bank holding company, was incorporated on February 7, 1984 for the purpose of providing financial services through its wholly-owned subsidiary, The First National Bank of Long Island. The consolidated entity is referred to as the "Corporation," and the Bank and its subsidiaries are collectively referred to as the "Bank."

The Bank was organized in 1927 as a national banking association under the laws of the United States of America. The Bank has two wholly owned subsidiaries: The First of Long Island Agency, Inc., a licensed insurance agency under the laws of the State of New York; and FNY Service Corp., an investment company. The Bank and FNY Service Corp. jointly own another subsidiary, The First of Long Island REIT, Inc., a real estate investment trust (“REIT”).

All of the financial operations of the Corporation are aggregated in one reportable operating segment. All revenues are attributed to and all long-lived assets are located in the United States.

The Bank’s revenues are derived principally from interest on loans and investment securities, service charges and fees on deposit accounts and income from investment management and trust services.

The Bank did not commence, abandon or significantly change any of its lines of business during 2016.

Markets Served and Products Offered

The Bank serves the financial needs of privately owned businesses, professionals, consumers, public bodies and other organizations primarily in Nassau and Suffolk Counties, Long Island, and the boroughs of New York City. The Bank’s head office is located in Glen Head, New York, and the Bank has thirty-four other full service branches, including a branch opened in February 2017, ten commercial banking offices and two select service banking centers. Included in these totals are three full service branches in Queens, one in Brooklyn and two commercial banking offices in Manhattan. The Bank continues to evaluate potential new branch sites on Long Island and in the boroughs of New York City.

The Bank's loan portfolio is primarily comprised of loans to borrowers on Long Island and in the boroughs of New York City, and its real estate loans are principally secured by properties located in those areas. The Bank's investment securities portfolio is comprised of direct obligations of the U.S. government and its agencies and highly rated obligations of states and political subdivisions. The Bank has an Investment Management Division that provides investment management, pension trust, personal trust, estate and custody services.

In addition to its loan and deposit products, the Bank offers other services to its customers including the following:

Account Reconciliation Services	Mobile Banking
ACH Origination	Mobile Capture
ATM Banking and Deposit Automation	Mutual Funds, Annuities and Life Insurance
Bank by Mail	Night Depository Services
Bill Payment	Online Banking
Cash Management Services	Payroll Services
Collection Services	Personal Money Orders
Controlled Disbursement Accounts	Remote Deposit
Drive-Through Banking	Safe Deposit Boxes
Foreign Currency Sales and Purchases	Securities Transactions
Healthcare Remittance Automation	Signature Guarantee Services
Instant Issue Debit Cards	Telephone Banking
Investment Management and Trust Services	Travelers Checks
Lock Box Services	Wire Transfers - Domestic and International
Merchant Credit Card Services	Withholding Tax Depository Services

Competition

The Bank encounters substantial competition in its banking business from numerous other financial services organizations that have offices located in the communities served by the Bank. Principal competitors are money center, large regional and community banks located within the Bank's market area, as well as mortgage brokers, brokerage firms and credit unions. The Bank competes for loans based on the quality of service it provides, loan structure, competitive pricing and branch locations, and competes for deposits by offering a high level of customer service, paying competitive rates and through the geographic distribution of its branch system.

Investment Activities

The investment policy of the Bank, as approved by the Board Asset Liability Committee ("BALCO") and supervised by both the BALCO and the Management Investment Committee, is intended to promote investment practices which are both safe and sound and in full compliance with applicable regulations. Investment authority will be granted and amended as is necessary by the Board of Directors or BALCO.

The Bank's investment decisions seek to optimize income while keeping both credit and interest rate risk at acceptable levels, provide for the Bank's liquidity needs and provide securities that can be pledged, as needed, to secure deposits and borrowings.

The Bank's investment policy generally limits individual maturities to twenty years and average lives on collateralized mortgage obligations ("CMOs") and other mortgage-backed securities to ten years. At the time of purchase, bonds of states and political subdivisions must generally be rated AA or better, notes of states and political subdivisions must generally be rated MIG-1 (or equivalent), commercial paper must be rated A-1 or P-1, and corporate bonds must be rated AA or better. In addition, management periodically reviews the creditworthiness of all securities in the Bank's portfolio other than those issued by the U.S. government or its agencies. Any significant deterioration in the creditworthiness of an issuer is analyzed and action is taken if deemed appropriate.

At year-end 2016 and 2015, there were no holdings of securities of any one issuer, other than the U.S. government and its agencies, in an amount greater than 10% of stockholders' equity.

At December 31, 2016, $458.6 million of the Corporation's municipal securities were rated AA or better and $2.4 million were non-rated bonds issued by local municipalities. The Corporation's pass-through mortgage securities portfolio at December 31, 2016 is comprised of $218.0 million and $147.6 million of securities issued by the Government National Mortgage Association ("GNMA") and the Federal National Mortgage Association ("FNMA"), respectively. Each issuer's pass-through mortgage securities are backed by residential mortgages conforming to the issuer's underwriting guidelines and each issuer guarantees the timely payment of principal and interest on its securities. All of the Corporation's CMOs were issued by GNMA and such securities are backed by GNMA residential pass-through mortgage securities. GNMA guarantees the timely payment of principal and interest on its CMOs and the underlying pass-through mortgage securities. Obligations of GNMA, a U.S. government agency, represent full faith and credit obligations of the U.S. government, while obligations of FNMA, which is a U.S. government-sponsored agency, do not.

The Bank has not engaged in the purchase and sale of securities for the primary purpose of producing trading profits and its current investment policy does not allow such activity.

Lending Activities

General. The Bank's lending is subject to written underwriting standards and loan origination procedures, as approved by the Board Loan Committee and contained in the Bank's loan policies. The loan policies allow for exceptions and set forth specific exception approval requirements. Decisions on loan applications are based on, among other things, the borrower's credit history, the financial strength of the borrower, estimates of the borrower's ability to repay the loan and the value of the collateral, if any. All real estate appraisals must meet the requirements of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), banking agency guidance and, for those loans in excess of $250,000, be reviewed by the Bank's independent appraisal review function.

The Bank conducts its lending activities out of its main office in Glen Head, New York and its Suffolk County regional office in Hauppauge, New York. The Bank's loan portfolio is primarily comprised of loans to small and medium-sized privately owned businesses, professionals and consumers on Long Island and in the boroughs of New York City. The Bank offers a full range of lending services including commercial and residential mortgage loans, home equity lines, commercial and industrial loans, small business credit scored loans, Small Business Administration ("SBA") loans, construction and land development loans, consumer loans and commercial and standby letters of credit. The Bank makes both fixed and variable rate loans. Variable rate loans are primarily tied to and reprice with changes in the prime interest rate of the Bank, the prime interest rate as published in The Wall Street Journal, U.S. Treasury rates, Federal Home Loan Bank of New York advance rates and the London Interbank Offered Rate (LIBOR).

Residential mortgage loans in excess of $1.0 million and other loans in excess of $750,000 generally require the approval of the Management Loan Committee. Loans in excess of $12.5 million require the additional approval of two non-management members of the Board Loan Committee, while those in excess of $17.5 million require the approval of a majority of the Board of Directors. If there has been no deterioration in risk rating, an existing credit facility over $15.0 million may be extended for twelve months or less with the approval of two non-management members of the Board Loan Committee.

Commercial and Industrial Loans. Commercial and industrial loans include, among other things, short-term business loans and lines of credit; term and installment loans; loans secured by marketable securities, the cash surrender value of life insurance policies, deposit accounts or general business assets; small business credit scored loans; and equipment finance loans. The Bank makes commercial and industrial loans on a demand basis, short-term basis, or installment basis. Short-term business loans are generally due and payable within one year and should be self-liquidating during the normal course of the borrower's business cycle. Lines of credit are reaffirmed annually and generally require an annual cleanup period. Term and installment loans are usually due and payable within five years. Generally, it is the policy of the Bank to request personal guarantees of principal owners on loans made to privately-owned businesses.

Small Business Credit Scored Loans. The Bank makes small business credit scored loans and issues VISA® credit cards to businesses that generally have annual sales at the time of application of less than $2 million. Most of these loans are in the form of revolving credit lines and, depending on the type of business, the maximum amount generally ranges from $100,000 to $500,000. Others are installment loans made to finance business automobiles, trucks and equipment and can be secured by the asset financed and/or deposit accounts with the Bank. Both installment loans and revolving credit commitments generally have maturities up to sixty months. Business profile reports are used in conjunction with credit reports and FICO (Fair Isaac Corporation) small business score cards for loan underwriting and decision making purposes. Credit and FICO small business risk scores enable the Bank to quickly and efficiently identify and approve loans to low-risk business applicants and decline loans to high-risk business applicants. There were $1.5 million of small business credit scored loans outstanding at December 31, 2016. In addition, the Bank had commitments on small business credit scored revolving lines of credit of $34.5 million, of which $14.1 million were drawn and funded.

Real Estate Mortgage Loans and Home Equity Lines. The Bank makes residential and commercial mortgage loans and establishes home equity lines of credit. Applicants for residential mortgage loans and home equity lines will be considered for approval provided they have satisfactory credit history and collateral and the Bank believes that there is sufficient monthly income to service both the loan or line applied for and existing debt. Applicants for commercial mortgage loans will be considered for approval provided they, as well as any guarantors, have satisfactory credit history and can demonstrate, through financial statements and otherwise, the ability to repay. Commercial and residential mortgage loans are made with terms not in excess of thirty years and are generally maintained in the Bank's portfolio. Many of the residential mortgage loans made by the Bank in recent years reprice in five, seven or ten years and then every year thereafter. Commercial mortgage loans generally reprice within five years and home equity lines generally mature within ten years. Depending on the type of property, the Bank will generally not lend more than 75% of appraised value on residential mortgage, home equity and commercial mortgage loans. The lending limitations with regard to appraised value are more stringent for loans on co-ops and condominiums.

In processing requests for commercial mortgage loans, the Bank generally requires an environmental assessment to identify the possibility of environmental contamination. The extent of the assessment procedures varies from property to property and is based on factors such as the use and location of the subject property and whether or not the property has a suspected environmental risk based on current or past use.

Construction Loans. From time to time, the Bank makes loans to finance the construction of both residential and commercial properties. The maturity of such loans is generally eighteen months or less and advances are made as the construction progresses. The advances can require the submission of bills by the contractor, verification by a Bank-approved inspector that the work has been performed, and title insurance updates to ensure that no intervening liens have been placed. Variable rate construction and land development loans are included in Commercial Mortgages on the Consolidated Balance Sheet and amounted to $2.6 million at December 31, 2016.

Consumer Loans and Lines. The Bank makes auto loans, home improvement loans and other consumer loans, establishes revolving overdraft lines of credit and issues VISA® credit cards. Consumer loans are generally made on an installment basis over terms not in excess of five years. In reviewing loans and lines for approval, the Bank considers, among other things, the borrower's ability to repay, stability of employment and residence, and past credit history.

Sources of Funds

The Corporation's primary sources of cash are deposits, maturities and amortization of loans and investment securities, operations, borrowings and funds from the Dividend Reinvestment and Stock Purchase Plan. The Corporation uses cash from these and other sources to fund loan growth, purchase investment securities, repay borrowings, expand and improve its physical facilities, pay cash dividends and for general operating purposes.

The Bank offers checking and interest-bearing deposit products. In addition to business and small business checking, the Bank has a variety of personal checking products that differ in minimum balance requirements, monthly maintenance fees, and per check charges, if any. The interest-bearing deposit products, which have a wide range of interest rates and terms, consist of checking accounts, which include negotiable order of withdrawal ("NOW") accounts and IOLA, escrow service accounts, rent security accounts, a variety of personal and nonpersonal money market accounts, a variety of personal and nonpersonal savings products, time deposits, holiday club accounts, and a variety of individual retirement accounts.

The Bank relies primarily on customer service, calling programs, lending relationships, referral sources, competitive pricing and advertising to attract and retain local deposits. The flow of deposits is influenced by general economic conditions, changes in interest rates and competition.

Employees

As of December 31, 2016, the Bank had 314 full-time equivalent employees and considers employee relations to be good. Employees of the Bank are not represented by a collective bargaining unit.

Supervision and Regulation

General. The banking industry is highly regulated. Statutory and regulatory controls are designed primarily for the protection of depositors and the banking system, and not for the purpose of protecting shareholders. The following discussion is not intended to be a complete list of all the activities regulated by banking laws or of the impact of such laws and regulations on the Corporation and the Bank. Changes in applicable laws or regulations, and in their interpretation and application by regulatory agencies, cannot be predicted, but may have a material effect on our business and results of operations.

As a registered bank holding company, the Corporation is regulated under the Bank Holding Company Act of 1956, as amended (“BHC Act”), and subject to inspection, examination and supervision by the Federal Reserve Board. In general, the BHC Act limits the business of bank holding companies to banking, managing or controlling banks, performing servicing activities for subsidiaries, and engaging in activities that the Federal Reserve has determined, by order or regulation, are so closely related to banking as to be a proper incident thereto under the BHC Act. The Corporation is also subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the Securities and Exchange Commission (“SEC”). Our common stock is listed on the Capital Market tier of the NASDAQ Stock Market (“NASDAQ”) under the symbol “FLIC” and is subject to NASDAQ rules for listed companies.

As a national bank, the Bank is subject to regulation and examination by the Office of the Comptroller of the Currency (“OCC”), as well as the Federal Deposit Insurance Corporation (“FDIC”). Insured banks, such as the Bank, are subject to extensive regulation of many aspects of their businesses. These regulations relate to, among other things: (i) the nature and amount of loans that may be made by the Bank and the rates of interest that may be charged; (ii) types and amounts of other investments; (iii) branching; (iv) permissible activities; (v) reserve requirements; and (vi) dealings with officers, directors and affiliates.

The Dodd-Frank Act made extensive changes in the regulation of depository institutions and their holding companies. Certain provisions of the Dodd-Frank Act are having an impact on the Corporation and the Bank. For example, the Dodd-Frank Act created a new Consumer Financial Protection Bureau (“CFPB”) as an independent bureau of the Federal Reserve Board. The CFPB has assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations, a function previously assigned to principal federal banking regulators, and has authority to impose new requirements. However, institutions of less than $10 billion in assets, such as the Bank, continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and be subject to the enforcement authority of, their primary federal regulator, although the CFPB has limited back-up authority to examine such institutions.

Bank Holding Company Regulation. The BHC Act requires the prior approval of the Federal Reserve Board for the acquisition by a bank holding company of 5% or more of the voting stock or substantially all of the assets of any bank or bank holding company. Also, under the BHC Act, bank holding companies are prohibited, with certain exceptions, from engaging in, or from acquiring 5% or more of the voting stock of any company engaging in, activities other than (i) banking or managing or controlling banks, (ii) furnishing services to or performing services for their subsidiaries or (iii) activities that the Federal Reserve Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Payment of Dividends. The principal source of the Corporation's liquidity is dividends from the Bank. The prior approval of the OCC is required if the total of all dividends declared by a national bank in any calendar year would exceed the sum of the bank's net profits for that year and its retained net profits for the preceding two calendar years, less any required transfers to surplus. Under the foregoing dividend restrictions, and while maintaining its "well-capitalized" status and absent affirmative governmental approvals, during 2017 the Bank could declare dividends to the Corporation of approximately $46.5 million plus any 2017 net profits retained to the date of the dividend declaration.

In addition, the Corporation and the Bank are subject to other regulatory policies and requirements relating to the payment of dividends, including requirements to maintain adequate capital above regulatory minimum capital levels. The Federal Reserve Board is authorized to determine under certain circumstances relating to the financial condition of a bank holding company or a bank that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. Federal Reserve guidance sets forth the supervisory expectation that bank holding companies will inform and consult with Federal Reserve staff in advance of declaring a dividend that exceeds earnings for the quarter and should inform the Federal Reserve and should eliminate, defer or significantly reduce dividends if (i) net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends, (ii) the prospective rate of earnings retention is not consistent with the bank holding company's capital needs and overall current and prospective financial condition, or (iii) the bank holding company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

Transactions with Affiliates. Federal laws strictly limit the ability of banks to engage in transactions with their affiliates, including their bank holding companies. Regulations promulgated by the Federal Reserve Board limit the types and amounts of these transactions (including loans due and extensions of credit from their U.S. bank subsidiaries) that may take place and generally require those transactions to be on an arm's-length basis. In general, these regulations require that any "covered transactions" between a subsidiary bank and its parent company or the nonbank subsidiaries of the bank holding company be limited to 10% of the bank subsidiary's capital and surplus and, with respect to such parent company and all such nonbank subsidiaries, to an aggregate of 20% of the bank subsidiary's capital and surplus. Further, loans and extensions of credit to affiliates generally are required to be secured by eligible collateral in specified amounts.

Source of Strength Doctrine. Federal Reserve policy has historically required bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. The Dodd-Frank Act codified this policy as a statutory requirement. Under this requirement, the Corporation is expected to commit resources to support the Bank, including at times when the Corporation may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to depositors and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a Federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

Capital Requirements. As a bank holding company, the Corporation is subject to consolidated regulatory capital requirements administered by the Federal Reserve. The Bank is subject to similar capital requirements administered by the OCC.

On January 1, 2015, the Corporation and the Bank implemented the Basel III regulatory capital standards ("Basel III" or "final rule") issued by the Federal Reserve Board and the OCC. Under the Basel III capital requirements, the Corporation and the Bank are required to maintain minimum ratios of capital to assets as follows: 4.00% for Tier 1 Capital to average assets, 4.50% for Common Equity Tier 1 Capital to risk weighted assets, 6.00% for Tier 1 Capital to risk weighted assets and 8.00% for Total Capital to risk weighted assets. Common Equity Tier 1 Capital, Tier 1 Capital, Total Capital, risk weighted assets and average assets are defined in the Basel III rules. Failure to meet the minimum capital requirements can result in certain mandatory and possibly additional discretionary actions by the regulators that, if undertaken, could have a direct material effect on the financial statements of the Corporation and Bank. The Corporation and the Bank exceeded the Basel III minimum capital adequacy requirements at December 31, 2016.

The final rule also phases-in a capital conservation buffer from 2016 through 2019. The capital conservation buffer must be maintained in order for a banking organization to avoid being subject to limitations on capital distributions, including dividend payments, and discretionary bonus payments to executive officers. The capital ratio phase-in schedule, including the capital conservation buffer, for banks with $250 billion or less in total assets is as follows:

	2015	2016	2017	2018	2019
Minimum Leverage Measure (%)	4.0	4.0	4.0	4.0	4.0
Minimum Common Equity Tier 1 Risk-Based Capital ("RBC") (%)	4.5	4.5	4.5	4.5	4.5
Capital Conservation Buffer (%)	N/A	.625	1.25	1.875	2.5
Minimum Common Equity Tier 1 RBC with Capital Conservation Buffer (%)	4.5	5.125	5.75	6.375	7.0
Minimum Tier 1 RBC (%)	6.0	6.0	6.0	6.0	6.0
Minimum Tier 1 RBC with Capital Conservation Buffer (%)	6.0	6.625	7.25	7.875	8.5
Minimum Total RBC (%)	8.0	8.0	8.0	8.0	8.0
Minimum Total RBC with Capital Conservation Buffer (%)	8.0	8.625	9.25	9.875	10.5

Prompt Corrective Action Regulations. The Federal Deposit Insurance Act, as amended ("FDIA"), requires among other things, the Federal banking agencies to take "prompt corrective action" with respect to banks that do not meet minimum capital requirements. The FDIA sets forth the following five capital tiers for purposes of implementing the prompt corrective action ("PCA") regulations: "well-capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." The PCA thresholds established by Basel III for each of the capital tiers is as follows:

	Total RBC Measure (%)	Tier 1 RBC Measure (%)	Common Equity Tier 1 RBC Measure (%)	Leverage Measure (%)
Well Capitalized	≥ 10	≥ 8	≥ 6.5	≥ 5
Adequately Capitalized	≥ 8	≥ 6	≥ 4.5	≥ 4
Undercapitalized	< 8	< 6	< 4.5	< 4
Significantly Undercapitalized	< 6	< 4	< 3	< 3
Critically Undercapitalized	Tangible equity to total assets ≤ 2			

The Bank was well capitalized under the Basel III PCA thresholds at December 31, 2016.

Deposit Insurance. The FDIC imposes an assessment on financial institutions for deposit insurance. The assessment is based on the risk category of the institution, the institution's average total assets and average tangible equity. The FDIC periodically adjusts the deposit insurance assessment rates, which may raise or lower the cost to an institution of maintaining FDIC insurance coverage.

The FDIC may terminate the insurance of an institution's deposits upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. Management is not aware of any practice, condition or violation that might lead to termination of the Bank's deposit insurance.

Safety and Soundness Standards. The FDIA requires the Federal bank regulatory agencies to prescribe standards, through regulations or guidelines, relating to internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, stock valuation and compensation, fees and benefits, and such other operational and managerial standards as the agencies deem appropriate. Guidelines adopted by the Federal bank regulatory agencies establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal stockholder. In addition, the agencies adopted regulations that authorize, but do not require, an agency to order an institution that has been given notice by an agency that it is not satisfying one or more of the safety and soundness standards to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan or fails in any material respect to implement an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the PCA provisions of the FDIA. If an institution fails to comply with such an order, the agency may seek to enforce such order in judicial proceedings and to impose civil money penalties.

Community Reinvestment Act and Fair Lending Laws. The Community Reinvestment Act of 1977 (“CRA”) requires depository institutions to assist in meeting the credit needs of their market areas consistent with safe and sound banking practice. Under the CRA, each depository institution is required to help meet the credit needs of its market areas by, among other things, providing credit to low and moderate income individuals and communities. Depository institutions are periodically examined for compliance with the CRA and are assigned ratings. Banking regulators take into account CRA ratings when considering approval of proposed acquisition transactions. The Bank received a “Satisfactory” CRA rating on its most recent Federal examination. The Bank and the Corporation are firmly committed to the practice of fair lending and maintaining strict adherence to all federal and state fair lending laws which prohibit discriminatory lending practices.

Federal Home Loan Bank System. The Bank is a member of the Federal Home Loan Bank System (“FHLB System”), which consists of 11 regional Federal Home Loan Banks (each a “FHLB”). The FHLB System provides a central credit facility primarily for member banks. As a member of the FHLB of New York, the Bank is required to acquire and hold shares of capital stock in the FHLB in an amount equal to 4.5% of its borrowings from the FHLB plus 0.15% of the total principal amount at the beginning of the year of the Bank’s unpaid residential real estate loans, commercial real estate loans, home equity loans, CMOs, and other similar obligations. At December 31, 2016, the Bank was in compliance with the FHLB’s capital stock ownership requirement.

Financial Privacy. Federal regulations require the Bank to disclose its privacy policy, including identifying with whom it shares “nonpublic personal information,” to its customers at the time the customer establishes a relationship with the Bank and annually thereafter. In addition, we are required to provide our customers with the ability to “opt-out” of having the Bank share their nonpublic personal information with nonaffiliated third parties before we can disclose that information, subject to certain exceptions.

The Federal banking agencies adopted guidelines establishing standards for safeguarding our customer information. The guidelines describe the agencies' expectation that regulated entities create, implement and maintain an information security program, which would include administrative, technical and physical safeguards appropriate to the size and complexity and the nature and scope of our activities. The standards set forth in the guidelines are intended to ensure the security and confidentiality of customer records and information, protect against any anticipated threats or hazards to the security or integrity of customer records, and protect against unauthorized access to records or information that could result in substantial harm or inconvenience to customers. Additionally, the guidance states that banks, such as the Bank, should develop and implement a response program to address security breaches involving customer information, including customer notification procedures. The Bank has developed such a program.

Anti-Money Laundering and the USA PATRIOT Act. A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001 ("Patriot Act") substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. The United States Treasury Department has issued and, in some cases, proposed a number of regulations that apply various requirements of the Patriot Act to financial institutions such as the Bank. These regulations impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing and to verify the identity of their customers. Certain of those regulations impose specific due diligence requirements on financial institutions that maintain correspondent or private banking relationships with non-U.S. financial institutions or persons. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal, financial and reputational consequences for the institution. The Bank and the Corporation are firmly committed to maintaining strong policies, procedures and controls to ensure compliance with anti-money laundering laws and regulations and to combat money laundering and terrorist financing.

Legislative Initiatives and Regulatory Reform. From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to change substantially the financial institution regulatory system. Such legislation could change banking statutes and the operating environment in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions and other financial institutions. The Corporation cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on our financial condition or results of operations. A change in statutes, regulations or regulatory policies applicable to the Corporation could have a material effect on our business.

Availability of Reports

The Bank maintains a website at www.fnbli.com. The Corporation's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports filed with or furnished to the SEC pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge through the Bank's website as soon as reasonably practicable after they are electronically filed with or furnished to the SEC. To access these reports go to the homepage of the Bank's website and click on "Investor Relations," then click on "SEC Filings," and then click on "Corporate SEC Filings." This will bring you to a listing of the Corporation's reports maintained on the SEC's EDGAR website. You can then click on any report to view its contents.

You may also read and copy any document we file with the SEC at the SEC's public reference room at 100 F Street, N.E., Washington, DC 20549. You should call 1-800-SEC-0330 for more information on the public reference room. Our SEC filings are also available on the SEC's website at www.sec.gov.

ITEM 1A. RISK FACTORS

The Corporation is exposed to a variety of risks, some of which are inherent in the banking business. The more significant of these are addressed by the Corporation's written policies and procedures. While management is responsible for identifying, assessing and managing risk, the Board of Directors is responsible for risk oversight. The Board fulfills its risk oversight responsibilities largely through its committees. The risks faced by the Corporation include, among others, credit risk, allowance for loan loss risk, interest rate risk, liquidity risk, market risk for its common stock, economic conditions risk, operational risk, technology and cybersecurity risk, key personnel risk, regulatory and legislative risk, income tax risk, external events risk and competitive risk. Additional risks and uncertainties not currently known to the Corporation, or that the Corporation currently deems to be immaterial, could also have a material impact on the Corporation's business, financial condition, or results of operations.

Credit Risk

For investment securities, loans and bank-owned life insurance, there is always the risk that the Bank will be unable to realize their full carrying value. Credit risk in the Bank's securities and bank-owned life insurance portfolios has been addressed by adopting board committee approved investment and bank-owned life insurance policies that, among other things, limit terms, types and amounts of holdings and specify minimum required credit ratings. Allowable investments include direct obligations of the U.S. government and its agencies, highly rated obligations of states and political subdivisions, highly rated corporate obligations and bank-owned life insurance policies issued by highly rated insurance carriers. At the time of purchase, bonds of states and political subdivisions must generally be rated AA or better, notes of states and political subdivisions must generally be rated MIG-1 (or equivalent), commercial paper must be rated A-1 or P-1, and corporate bonds must be rated AA or better. Bank-owned life insurance may only be purchased from insurance carriers rated A or better. For carriers rated AA or better, cash surrender value is limited to 15% of Tier 1 Capital, and for those carriers rated below AA, the limitation is 10% of Tier 1 Capital. The cash surrender value of policies with all carriers, plus corporate bond holdings of such carriers, cannot exceed 25% of Tier 1 Capital. Management periodically reviews the creditworthiness of all securities in the Bank's portfolio other than those issued by the U.S. government or its agencies, and all bank-owned life insurance carriers. Any significant deterioration in the creditworthiness of an issuer or carrier will be analyzed and action taken if deemed appropriate.

Credit risk in the Bank's loan portfolio has been addressed by adopting a board committee approved loan policy and by maintaining independent loan and appraisal review functions and an independent credit department. The loan policy contains what the Corporation believes to be prudent underwriting guidelines, which include, among other things, specific loan approval requirements, maximum loan terms, loan to appraised value and debt service coverage limits for mortgage loans, credit score minimums and environmental study requirements.

The credit risk within the Bank's loan portfolio primarily stems from factors such as borrower size, geographic concentration, industry concentration, real estate values, local and national economic conditions and environmental contamination. The Bank's commercial loans, including those secured by mortgages, are primarily made to small and medium-sized businesses. Such loans sometimes involve a higher degree of risk than those to larger companies because such businesses may have shorter operating histories, higher debt-to-equity ratios and may lack sophistication in internal record keeping and financial and operational controls. In addition, most of the Bank's loans are made to businesses and consumers on Long Island and in the boroughs of New York City, and a large percentage of these loans are mortgage loans secured by properties located in those areas. At December 31, 2016, multifamily loans amounted to approximately $610 million and comprised approximately 56% of the Bank's total commercial mortgage portfolio and approximately 25% of the Bank's total loans secured by real estate. The primary source of repayment for multifamily loans is cash flows from the underlying properties, a substantial portion of which are rent stabilized or rent controlled. Such cash flows are dependent on the strength of the local economy.

Although the economy has improved, national and local economic conditions remain suboptimal. These conditions have caused some of the Bank's borrowers to be unable to make the required contractual payments on their loans and could cause the Bank to be unable to realize the full carrying value of such loans through its collection efforts. Environmental impairment of properties securing mortgage loans is also a risk. However, at the present time, the Bank is not aware of any existing loans in the portfolio where there is environmental pollution originating on or near the mortgaged properties that would materially affect the value of the portfolio.

Allowance for Loan Loss Risk

The Bank maintains an allowance for loan losses in an amount believed to be adequate to absorb probable incurred losses in its loan portfolio. The maintenance of the allowance for loan losses is governed by a board committee approved allowance for loan and lease losses policy. In arriving at the allowance for loan losses, an impairment analysis is performed on each loan where it is probable that the borrower will not be able to make all required principal and interest payments according to contractual terms. In addition, incurred losses for all other loans in the Bank's portfolio are determined on a pooled basis taking into account, among other things, historical loss experience, delinquencies, economic conditions, trends in nature and volume of loans, concentrations of credit, changes in lending policies and procedures, experience, ability and depth of lending staff, changes in quality of the loan review function, environmental risks and loan risk ratings. Because estimating the allowance for loan losses is highly subjective in nature and involves a variety of estimates and assumptions that are inherently uncertain, there is the risk that management's estimate may not accurately capture probable incurred losses in the loan portfolio. The Bank's allowance may need to be increased based on, among other things, additional information that comes to light after the estimate is made, changes in circumstances or a recommendation by bank regulators based on their review of the Bank's loan portfolio. The impact of one or more of these factors on the Bank's allowance could result in the need for a significant increase in the Bank's provision for loan losses and have a material adverse impact on the Bank's financial condition and results of operations.

In addition, the Financial Accounting Standards Board has adopted a new accounting standard, ASU 2016-13, that will be effective for reporting periods beginning after December 15, 2019. This new standard changes the accounting methodology used to determine the allowance for loan losses from an incurred loss model to a current expected credit loss model, or CECL. The CECL model will require the Bank to maintain at each periodic reporting date an allowance for loan losses in an amount that is equal to its estimate of expected lifetime credit losses on the loans in its portfolio. Utilization of the CECL model may require the Bank to increase its allowance for loan losses and will increase the types and amount of data the Bank will need to collect and consider in determining an appropriate level for its allowance for loan losses.

Interest Rate Risk

The Bank’s results of operations are subject to risk resulting from interest rate fluctuations and having assets and liabilities that have different maturity, repricing and prepayment/withdrawal characteristics. The Bank defines interest rate risk as the risk that the Bank's net interest income and/or economic value of equity (“EVE”) will change when interest rates change. The Bank has addressed interest rate risk by adopting a board committee approved interest rate risk policy which sets forth quantitative risk limits and calls for monitoring and controlling interest rate risk through a variety of techniques including the use of interest rate sensitivity models and traditional repricing gap analysis. Management utilizes a consultant with expertise in bank asset liability management to aid them in these efforts.

A sustained period of low interest rates could adversely affect the Bank’s earnings. When interest rates are low, as they currently are, borrowers tend to refinance higher rate loans at lower rates and prepayments on mortgages and mortgage-backed securities are elevated. Under those circumstances, the Bank may not be able to reinvest the resulting cash flows in new interest-earning assets with rates as favorable as those on the prepaid loans or investment securities. In addition, subject to the floors contained in many of the Bank’s loan agreements, the Bank’s loans at variable interest rates may adjust to lower rates at their reset dates. The positive impact of lower interest rates on the Bank’s cost of funds is currently constrained because many of the Bank’s deposit products are at historically low rates with little if any room for further reductions, and because the Bank funds a significant portion of its average interest-earning assets with noninterest bearing checking deposits and capital.

Increases in the federal funds target rate could exert upward pressure on non-maturity deposit liability rates. In a period of rising interest rates, the Bank’s loans and investment securities could reprice slower than its interest-bearing liabilities, which could initially have a negative effect on net interest income. Over a longer period of time, the effect on the Bank’s earnings should be positive primarily because with the passage of time more loans and investment securities will reprice at the higher rates and there will be no offsetting increase in interest expense for those interest-earning assets funded by noninterest-bearing checking deposits and capital.

Liquidity Risk

Liquidity risk is the risk that the Bank will not have sufficient funds to accommodate loan growth, meet deposit outflows or make contractual payments on borrowing arrangements. The Bank has addressed liquidity risk by adopting a board committee approved Liquidity Policy and Liquidity Contingency Plan that set forth quantitative risk limits and a protocol for responding to liquidity stress conditions should they arise. The Bank encounters significant competition in its market area from branches of larger banks, various community banks, credit unions and other financial services organizations. This, in addition to renewed consumer confidence in the equity markets, could cause deposit outflows, and such outflows could be significant.

The Bank has both internal and external sources of liquidity that can be used to fund loan growth and accommodate deposit outflows. The Bank’s primary internal sources of liquidity are overnight investments, investment securities designated as available-for-sale, maturities and monthly payments on its investment securities and loan portfolios and operations.

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The Bank is a member of the Federal Reserve Bank of New York ("FRB") and the FHLB of New York, and has a federal funds line with a commercial bank. In addition to customer deposits, the Bank's primary external sources of liquidity are secured borrowings from the FRB and FHLB of New York. In addition, the Bank can purchase overnight federal funds under its existing line. However, the Bank's FRB membership, FHLB of New York membership and federal funds line do not represent legal commitments to extend credit to the Bank. The amount that the Bank can potentially borrow is currently dependent on, among other things, the amount of unencumbered eligible securities and loans that the Bank can use as collateral and the collateral margins required by the lenders.

Market Risk for the Corporation's Common Stock

The Corporation's common stock is included in the Russell 3000 and Russell 2000 Indexes, which are reconstituted annually. Upon reconstitution in May 2016, the average market capitalization of companies in the Russell 2000 Index was $1.7 billion, the median market capitalization was $692 million, the capitalization of the largest company in the index was $2.9 billion and the capitalization of the smallest company in the index was $133 million. The Corporation's market capitalization on December 31, 2016 was approximately $677 million. The Corporation believes that inclusion in the Russell indexes has positively impacted the price, trading volume and liquidity of its common stock. Conversely, if the Corporation's market capitalization falls below the minimum necessary to be included in the indexes at any future reconstitution date, the opposite could occur.

Economic Conditions Risk

Although the economy has improved, national and local economic conditions remain suboptimal. This poses risks to both the Corporation's business and the banking industry as a whole. Specific risks include reduced loan demand from quality borrowers; increased competition for loans; increased loan loss provisions resulting from deterioration in loan quality; reduced net interest income and net interest margin caused by a sustained period of low interest rates; interest rate volatility; price competition for deposits due to liquidity concerns or otherwise; volatile equity markets; and higher cost to attract capital to support growth.

In addition to the significant risks posed by economic conditions, the Corporation could experience deposit outflows as national and local economic conditions improve and investors pursue alternative investment opportunities.

Operational Risk

The Corporation relies on its system of internal controls and the internal controls of its third-party service providers ("TPSPs") to ensure that transactions are captured, recorded, processed and reported properly; confidential customer information is safeguarded; and fraud by employees and persons outside the Corporation is detected and prevented. The Corporation's internal controls and/or those of its TPSPs may prove to be ineffective or employees of the Corporation and/or its TPSPs may fail to comply with or override the controls, either of which could result in significant financial loss to the Corporation, adverse action by bank regulatory authorities or the SEC and damage to the Corporation's reputation.

Technology and Cybersecurity Risk

The delivery of financial products and services has increasingly become technology-driven. The Bank's ability to competitively meet the needs of its customers in a cost-efficient manner is dependent on its ability to keep pace with technological advances and to invest in new technology as it becomes available. The ability to keep pace with technological change is important, and failure to do so could have a material adverse impact on the Corporation's business, financial condition and results of operations.

In addition, the Bank outsources most of its data processing to TPSPs. If TPSPs encounter difficulties, or if the Bank has difficulty communicating with them, the Bank's ability to adequately process and account for customer transactions could be affected, and the Bank's business operations could be adversely impacted. Threats to information security also exist in the processing of customer information through TPSPs. The Bank's website and online banking products have been the target of cyber attacks in the past. While the Bank and its TPSPs believe they have successfully blocked attempts to infiltrate the Bank's systems, there is always the possibility that successful attacks have not yet been identified.

The Bank has established board committee approved policies to prevent or limit the impact of systems failures, interruptions and security breaches and relies on commonly used security and processing systems to provide the security and authentication necessary for the processing of data. The Bank makes use of logon and user access controls, multifactor and out of band authentication, transaction limits, firewalls, antivirus software, intrusion protection monitoring, vulnerability scans and independent penetration testing. The Bank also ensures employee awareness of cybersecurity trends. System failures or interruptions are addressed in the Bank's emergency and disaster recovery policy and its incident response and business continuity plans. In addition, for TPSPs of data processing and other significant services, the Bank obtains and reviews audit reports prepared by independent registered public accounting firms regarding their financial condition and the effectiveness of their internal controls.

These precautions may not protect our systems from all compromises or breaches of security and there can be no assurance that such events will not occur or that they will be adequately addressed if they do. The Bank carries a cyber liability insurance policy to mitigate the amount of any financial loss. However, the occurrence of any systems failure, interruption or breach of security could damage the Bank's reputation and result in a loss of customers and business, could subject the Bank to additional regulatory scrutiny, or could expose the Bank to civil litigation and possible financial liability beyond any insurance coverage. Any of these occurrences could have a material adverse effect on the Corporation's financial condition and results of operations.

Key Personnel Risk

The Corporation's future success depends in part on the continued service of its executive officers and other key members of management and its staff, as well as its ability to continue to attract, motivate and retain additional highly qualified employees. The loss of services of key personnel and our inability to timely recruit or promote qualified replacements could have an adverse effect on the Bank's business, operating results and financial condition. Their skills, knowledge of the Bank's market and years of industry experience may be difficult to replace.

Regulatory and Legislative Risk

The Corporation and the Bank are subject to regulation, supervision and examination by, among others, the Federal Reserve Board, OCC and FDIC, which also insures the Bank's deposits. Regulation and supervision govern the activities in which a bank and its holding company may engage and are intended primarily for the protection of depositors. Regulatory requirements affect virtually all aspects of the Corporation's and the Bank's business, including investment practices, lending practices, deposit offerings and capital levels. The regulators have extensive discretion in connection with their supervisory and enforcement activities, including imposing restrictions on bank operations and expansion plans, imposing deposit insurance premiums and other assessments, setting required levels for the allowance for loan losses, capital and liquidity, and imposing restrictions on the ability to pay cash dividends and other capital distributions to stockholders. Changes in laws, regulations and supervisory guidance, or the Corporation's and the Bank's compliance with these laws and regulations as judged by the regulators, could have a significant negative impact on the Corporation's financial condition and results of operations. The Corporation manages the risk of noncompliance with laws and regulations by having board committee approved compliance policies, hiring and retaining employees with the experience and skills necessary to address compliance on an ongoing basis, and consulting, when necessary with legal counsel and other outside experts on compliance matters.

Income Tax Risk

The Corporation is subject to income tax under Federal, New York State, New Jersey, Connecticut and New York City laws and regulations. Changes in such laws and regulations, including laws and regulations associated with having a captive REIT, could increase the Corporation's tax burden and such increase could have a material negative impact on its results of operations.

External Events Risk – Weather and Terrorism

Weather-related events have adversely impacted our market area, especially areas located near coastal waters and flood prone areas. Significant flooding and other storm-related damage may become more common in the future. Financial institutions have been, and continue to be, targets of terrorist threats aimed at compromising operating and communication systems, and the metropolitan New York area remains a central target for potential acts of terrorism. Weather-related and terrorist events could cause significant damage, impact the stability of our facilities and result in additional operating expenses, impair the ability of our borrowers to repay their loans, reduce the value of collateral securing repayment of our loans and result in the loss of revenue. While we have established and regularly test disaster recovery procedures, the occurrence of any such event could have a material adverse effect on our business, results of operations and financial condition.

Competitive Risk

Competition in the banking and financial services industry is intense. In our market area, we compete with numerous commercial banks, savings institutions, mortgage brokers, credit unions, finance companies, mutual funds, insurance companies and brokerage and investment banking firms operating locally and elsewhere. Some of our competitors have substantially greater resources and lending limits than we have and have greater name recognition and market presence that benefit them in attracting business. In addition, large competitors may be able to price loans and deposits more aggressively than we do. Competitive forces may limit our ability to increase our interest-earning assets. Our profitability depends upon our continued ability to successfully compete in our market area. For additional information see “Item 1 – Business – Competition.”

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Corporation neither owns nor leases any real estate. Office facilities of the Corporation and the Bank’s main office are located at 10 Glen Head Road, Glen Head, New York in a building owned by the Bank.

As of December 31, 2016, the Bank owns 22 buildings and leases 33 other facilities, all of which are in Nassau and Suffolk Counties, Long Island and the New York City boroughs of Queens, Brooklyn and Manhattan. The Corporation believes that the physical facilities of the Bank are suitable and adequate at present and are being fully utilized.

ITEM 3. LEGAL PROCEEDINGS

In the ordinary course of business, the Corporation is party to various legal actions which are incidental to the operation of its business. Although the ultimate outcome and amount of liability, if any, with respect to these legal actions cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is believed to be immaterial to the Corporation's consolidated financial position, results of operations and cash flows.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

The Corporation's common stock trades on the NASDAQ Capital Market tier of the NASDAQ Stock Market under the symbol "FLIC." At December 31, 2016, there were 702 stockholders of record of the Corporation's Common Stock. The number of stockholders of record includes banks and brokers who act as nominees, each of whom may represent more than one stockholder. The following table sets forth high and low sales prices and dividends declared, by quarter, for the years ended December 31, 2016 and 2015, adjusted to reflect the 2016 stock split.

	2016			2015		
Quarter	High	Low	Dividends Declared	High	Low	Dividends Declared
First	$20.33	$17.43	$ .13	$18.91	$15.50	$ .13
Second	21.29	18.06	.13	19.29	15.99	.13
Third	22.35	18.68	.14	19.16	15.21	.13
Fourth	29.67	20.99	.14	21.28	17.36	.13

Performance Graph

The following performance graph compares the Corporation's total stockholder return with the NASDAQ U.S. Benchmark and NASDAQ U.S. Benchmark Banks Indexes over a 5-year measurement period assuming $100 invested on January 1, 2012, and dividends reinvested in the Corporation's stock.

Issuer Purchase of Equity Securities

The Corporation did not repurchase any shares of its own common stock in the fourth quarter of 2016.

ITEM 6. SELECTED FINANCIAL DATA

The following is selected consolidated financial data for the past five years, adjusted as appropriate to reflect the Corporation's stock splits. This data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the accompanying consolidated financial statements and related notes.

	2016	2015	2014	2013	2012
	(dollars in thousands, except per share data)				
INCOME STATEMENT DATA:					
Interest Income	$104,123	$92,135	$81,976	$74,851	$76,229
Interest Expense	18,002	16,529	15,048	12,364	16,127
Net Interest Income	86,121	75,606	66,928	62,487	60,102
Provision for Loan Losses	3,480	4,317	3,189	2,997	3,628
Net Income	30,880	25,890	23,014	21,300	20,393
PER SHARE DATA:					
Basic Earnings	$1.35	$1.23	$1.11	$1.04	$1.02
Diluted Earnings	1.34	1.22	1.10	1.03	1.01
Cash Dividends Declared	.55	.52	.48	.45	.43
Dividend Payout Ratio	41.04 %	42.62 %	43.64 %	43.69 %	42.57 %
Book Value	$12.90	$11.85	$11.20	$10.04	$10.14
Tangible Book Value	12.90	11.84	11.19	10.03	10.13
BALANCE SHEET DATA AT YEAR END:					
Total Assets	$3,510,320	$3,130,343	$2,721,494	$2,399,892	$2,108,290
Loans	2,545,421	2,248,183	1,804,819	1,477,937	1,147,384
Allowance for Loan Losses	30,057	27,256	23,221	20,848	18,624
Deposits	2,608,717	2,284,675	1,985,025	1,782,128	1,633,076
Borrowed Funds	586,224	577,214	481,486	395,463	248,634
Stockholders' Equity	305,830	250,936	233,303	206,556	205,370
AVERAGE BALANCE SHEET DATA:					
Total Assets	$3,329,308	$2,897,548	$2,515,103	$2,240,139	$2,057,608
Loans	2,364,187	1,990,823	1,584,198	1,286,227	1,073,046
Allowance for Loan Losses	28,238	24,531	21,554	19,847	18,098
Deposits	2,590,988	2,215,883	1,922,172	1,747,888	1,578,233
Borrowed Funds	432,554	419,372	347,946	272,737	257,392
Stockholders' Equity	290,806	243,330	224,585	203,125	200,137
FINANCIAL RATIOS:					
Return on Average Assets (ROA)	.93 %	.89 %	.92 %	.95 %	.99 %
Return on Average Stockholders' Equity (ROE)	10.62 %	10.64 %	10.25 %	10.49 %	10.19 %
Average Equity to Average Assets	8.73 %	8.40 %	8.93 %	9.07 %	9.73 %

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

Overview – 2016 Versus 2015

Analysis of 2016 Earnings. Net income and earnings per share for 2016 were $30.9 million and $1.34, respectively, representing increases of 19.3% and 9.8%, respectively, over the comparable 2015 amounts. Dividends per share increased 5.8% from $.52 for 2015 to $.55 for 2016. Returns on average assets and average equity for 2016 were .93% and 10.62%, respectively, as compared to .89% and 10.64%, respectively, for 2015.

Net income for 2016 increased $5.0 million over 2015. The increase is primarily attributable to an increase in net interest income of $10.5 million, or 13.9%, and a decrease in the provision for loan losses of $837,000. The impact of these items was partially offset by increases in noninterest expense, before debt extinguishment costs, of $4.7 million and income tax expense of $1.6 million.

The increase in net interest income was primarily driven by growth in average interest-earning assets of $431.2 million, or 15.4%, partially offset by a seven basis point decline in net interest margin. Average interest-earning assets grew mostly because of increases in the average balances of loans of $373.4 million, or 18.8%, and securities of $45.6 million, or 5.7%. Although most of the loan growth occurred in mortgage loans, commercial and industrial loans also grew with an increase in average outstandings of $23.5 million, or 27.5%. The growth in loans and securities was primarily funded by growth in the average balances of noninterest-bearing checking deposits of $56.0 million, or 7.6%, interest-bearing deposits of $319.1 million, or 21.6%, and stockholders' equity of $47.5 million, or 19.5%.

The decrease in the provision for loan losses for 2016 versus the prior year is largely due to lesser loan growth, a decline in historical loss rates and a lower increase in specific reserves. These items were partially offset by higher net chargeoffs in 2016.

The increase in noninterest expense, before debt extinguishment costs, of $4.7 million, or 10.4%, is largely attributable to increases in salaries, employee benefits expense, consulting expense, occupancy and equipment expense and computer and telecommunications expense. The increase in consulting expense includes a one-time charge of $800,000 in 2016 for advisory services rendered in renegotiating the Bank's data processing contract. The Corporation expects that the cost savings negotiated by the consultant over the life of the contract will far exceed the one-time consulting charge.

In the fourth quarter of 2016, the Corporation adopted ASU 2016-09 "Improvements to Employee Share-Based Payment Accounting" effective as of January 1, 2016. Adoption of the ASU increased 2016 net income through a credit to income tax expense in the amount of $385,000, or $.02 per share.

The increase in income tax expense is attributable to higher pre-tax earnings in 2016 as compared to the prior year, partially offset by the credit to income tax expense from the adoption of ASU 2016-09, additional New York State income tax benefits derived from the Corporation's captive REIT and the inclusion of a one-time charge of $402,000 in 2015 caused by changes in New York City tax law.

Analysis of Fourth Quarter 2016 Earnings. Net income for the fourth quarter of 2016 was $7.5 million, an increase of $900,000, or 13.6%, over $6.6 million earned in the same quarter last year. Earnings per share was $.31 for the fourth quarter of 2016, unchanged from the fourth quarter of 2015. The increase in net income is primarily attributable to an increase in net interest income of $2.1 million, partially offset by increases in salaries of $133,000, occupancy and equipment expense of $182,000 and income tax expense of $414,000, and a partial writedown of $168,000 on the Bank's investment in a trade association. The increases in net interest income, salaries and occupancy and equipment expense occurred for substantially the same reasons discussed with respect to the full year periods. Excluding the aforementioned one-time charge of $402,000, income tax expense also increased for the same reasons discussed with respect to the full year periods.

Asset Quality. The Bank's allowance for loan losses to total loans decreased three basis points from 1.21% at year-end 2015 to 1.18% at year-end 2016. The decrease is primarily due to improved economic conditions and a reduction in the historical loss component of the allowance for loan losses.

The credit quality of the Bank's loan portfolio remains excellent. Nonaccrual loans amounted to $2.6 million, or .10% of total loans outstanding, at December 31, 2016, compared to $1.4 million, or .06%, at December 31, 2015. Troubled debt restructurings amounted to $1.5 million, or .06% of total loans outstanding at December 31, 2016. Of the troubled debt restructurings, $757,000 are performing in accordance with their modified terms and $788,000 are nonaccrual and included in the aforementioned amount of nonaccrual loans. Troubled debt restructurings declined $2.9 million during 2016 from $4.5 million at year-end 2015. The decrease is primarily attributable to the payoff of two loans to one borrower, partially offset by two loans that were restructured in troubled debt restructurings during the year. Loans past due 30 through 89 days amounted to $1.1 million, or .04% of total loans outstanding, at

December 31, 2016, compared to $1.0 million, or .04%, at December 31, 2015.

The credit quality of the Bank's securities portfolio also remains excellent. The Bank's mortgage securities are backed by mortgages underwritten on conventional terms, with 60% of these securities being full faith and credit obligations of the U.S. government and the balance being obligations of U.S. government sponsored entities. The remainder of the Bank's securities portfolio principally consists of high quality, general obligation municipal securities rated AA or better by major rating agencies. In selecting municipal securities for purchase, the Bank uses credit agency ratings for screening purposes only and then performs its own credit analysis. On an ongoing basis, the Bank periodically assesses the credit strength of the municipal securities in its portfolio and makes decisions to hold or sell based on such assessments.

Key Strategic Initiatives. Key strategic initiatives will continue to include loan and deposit growth through effective relationship management, targeted solicitation efforts, new product offerings and continued expansion of the Bank's branch distribution system on Long Island and in the New York City boroughs of Queens and Brooklyn. With respect to loan growth, the Bank will continue to prudently manage concentration risk and further develop its broker and correspondent relationships. Small business credit scored loans, equipment finance loans and SBA loans, along with the Bank's traditional commercial and industrial loan products, will be originated to diversify the Bank's loan portfolio and help mitigate the impact of the low rate environment on the Bank's earnings.

The Bank's growing branch distribution system currently consists of 47 branches in Nassau and Suffolk Counties, Long Island and the boroughs of Queens, Brooklyn and Manhattan. The Bank expects to open two more branches in 2017 and continues to evaluate sites for further branch expansion. The two new branches will be in East Setauket, Long Island and Marine Park, Brooklyn. In addition to loan and deposit growth, management is also focused on growing noninterest income from existing and potential new sources, which may include the acquisition of fee-based businesses.

Challenges We Face. The federal funds target rate increased by 25 basis points in December 2016 and December 2015. Further increases could exert upward pressure on non-maturity deposit rates. Intermediate and long-term interest rates also increased during the fourth quarter of 2016. Nevertheless, they remain low and could move lower in the foreseeable future. This could cause investing and lending rates to be suboptimal. There is significant price competition for loans in the Bank's marketplace and little room for the Bank to further reduce its deposit rates. These factors will make it difficult to improve net interest margin and could result in a decline in net interest margin from its current level and inhibit earnings growth for the foreseeable future.

The banking industry continues to be faced with new and complex regulatory requirements and enhanced supervisory oversight. The new President has indicated that regulatory relief will be forthcoming, but the timing, magnitude and impact of any such relief is yet to be determined. In the current environment, banking regulators are increasingly concerned about, among other things, growth, commercial real estate concentrations, underwriting of commercial real estate and commercial and industrial loans, capital levels, cyber security and, as of late, predatory sales practices. Regulatory requirements and enhanced oversight are exerting downward pressure on revenues and upward pressure on required capital levels and the cost of doing business.

Overview – 2015 Versus 2014

Analysis of 2015 Earnings. Net income and earnings per share for 2015 were $25.9 million and $1.22, respectively, representing increases of 12.5% and 10.9%, respectively, over the comparable 2014 amounts. Dividends per share increased 8.3% from $.48 for 2014 to $.52 for 2015. Returns on average assets and average equity for 2015 were .89% and 10.64%, respectively, as compared to .92% and 10.25%, respectively, for 2014.

Net income for 2015 increased $2.9 million over 2014. The increase was attributable to increases in net interest income of $8.7 million, or 13.0%, and noninterest income, before securities gains, of $174,000, or 2.4%. The positive impact of these items on earnings was partially offset by an increase in noninterest expense, before debt extinguishment costs, of $3.6 million, or 8.5%, and increases in the provision for loan losses and income tax expense of $1.1 million and $1.4 million, respectively.

The increase in net interest income was driven by growth in average interest-earning assets of $365.6 million, or 15.0%, as partially offset by an eight basis point decline in net interest margin. The growth in average interest-earning assets was primarily comprised of growth in the average balances of loans of $406.6 million, or 25.7%, and nontaxable securities of $23.9 million, or 5.8%, partially offset by a decrease in the average balance of taxable securities of $68.8 million, or 16.2%. The growth in the average balance of loans included growth in commercial and industrial loans of $11.3 million, or 14.8%, a large portion of which resulted from the Bank’s small business credit scored loan initiative. The shift from taxable securities to better yielding loans and nontaxable securities partially mitigated the negative impact on net interest income of a low interest rate environment. The growth in loans and nontaxable securities, to the extent not funded by the decline in taxable securities, was funded by growth in the average balances of noninterest-bearing checking deposits of $99.0 million, or 15.5%, interest-bearing deposits of $194.7 million, or 15.1%, and long-term debt of $64.5 million, or 21.5%. The increase in long-term debt resulted from management’s desire to reduce the impact that an eventual increase in interest rates could have on the Bank’s earnings. Net interest margin declined from 3.04% in 2014 to 2.96% in 2015 as loans were repriced and cash flows were deployed in a low interest rate environment.

The $174,000 increase in noninterest income before securities gains was primarily attributable to real estate and sales tax refunds in 2015 and increases in merchant services income and cash value accretion on bank-owned life insurance.

The impact of these items was partially offset by a decrease in service charges on deposit accounts and a net gain during 2014 on the sale of loans held-for-sale. The $3.6 million increase in noninterest expense before debt extinguishment costs was primarily attributable to increases in salaries and employee benefits expense, a growth-related increase in the combined amount of the Bank's FDIC insurance expense and OCC assessment and a one-time charge resulting from the termination of certain network and communication-related contracts. The impact of these items was partially offset by a decrease in occupancy and equipment expense. The increase in income tax expense was attributable to an increase in pretax earnings and changes in New York City income tax law effective January 1, 2015, partially offset by changes in New York State tax law also effective January 1, 2015.

Analysis of Fourth Quarter 2015 Earnings. Net income for the fourth quarter of 2015 was $6.6 million, an increase of 21.2% over $5.5 million earned in the same quarter of 2014. Earnings per share was $.31 for the fourth quarter of 2015, an increase of 19.2% over $.26 for the same quarter of 2014. The increase in net income was primarily attributable to an increase in net interest income of $3.1 million, or 18.2%, net gains on sales of securities of $191,000 and a decrease in occupancy and equipment expense of $274,000. The positive impact on earnings of these items was partially offset by increases in salaries of $143,000, employee benefits expense of $395,000, other noninterest expense of $257,000, the provision for loan losses of $870,000 and income tax expense of $751,000. The increases in net interest income, salaries, employee benefits expense, other noninterest expense and income tax expense and the decrease in occupancy and equipment expense occurred for substantially the same reasons discussed with respect to the full year periods. The increase in the provision for loan losses was primarily attributable to the fact that the fourth quarter of 2014 included a decline in average annualized historical losses and an improvement in economic conditions.

Asset Quality. The Bank's allowance for loan losses to total loans decreased by eight basis points from 1.29% at year-end 2014 to 1.21% at December 31, 2015. The decrease was primarily due to improved economic conditions, partially offset by an increase in specific reserves on loans individually deemed to be impaired.

The credit quality of the Bank's loan portfolio remained excellent at December 31, 2015. Nonaccrual loans, including loans held-for-sale, amounted to $1.4 million, or .06% of total loans outstanding, at December 31, 2015, compared to $1.7 million, or .09%, at December 31, 2014. The decrease in nonaccrual loans was primarily attributable to paydowns and loan sales. Troubled debt restructurings increased $2.5 million during 2015 to $4.5 million at year-end. Of this amount, $3.6 million were performing in accordance with their modified terms and $900,000 were nonaccrual and included in the aforementioned amount of nonaccrual loans. Loans past due 30 through 89 days amounted to $1.0 million, or .04% of total loans outstanding, at December 31, 2015, compared to $2.2 million, or .12%, at December 31, 2014. The increase in troubled debt restructurings during 2015 was attributed to one lending relationship.

The credit quality of the Bank’s securities portfolio also remained excellent. The Bank’s mortgage securities are backed by mortgages underwritten on conventional terms, with 69% of these securities being full faith and credit obligations of the U.S. government and the balance being obligations of U.S. government sponsored entities. The remainder of the Bank’s securities portfolio principally consists of high quality, general obligation municipal securities rated AA or better by major rating agencies.

Application of Critical Accounting Policies

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported asset and liability balances and revenue and expense amounts. Our determination of the allowance for loan losses is a critical accounting estimate because it is based on our subjective evaluation of a variety of factors at a specific point in time and involves difficult and complex judgments about matters that are inherently uncertain. In the event that management’s estimate needs to be adjusted based on, among other things, additional information that comes to light after the estimate is made or changes in circumstances, such adjustment could result in the need for a significantly different allowance for loan losses and thereby materially impact, either positively or negatively, the Bank’s results of operations.

The Bank’s Allowance for Loan and Lease Losses Committee (“ALLL Committee”), which is a management committee chaired by the Chief Credit Officer, meets on a quarterly basis and is responsible for determining the allowance for loan losses after considering, among other things, the results of credit reviews performed by the Bank’s independent loan review consultants and the Bank’s credit department. In addition, and in consultation with the Bank’s Chief Financial Officer and Chief Risk Officer, the ALLL Committee is responsible for implementing and maintaining accounting policies and procedures surrounding the calculation of the required allowance. The Board Loan Committee reviews and approves the Bank’s Loan Policy at least once each calendar year. The Bank’s allowance for loan losses is reviewed and ratified by the Board Loan Committee on a quarterly basis and is subject to periodic examination by the OCC whose safety and soundness examination includes a determination as to the adequacy of the allowance for loan losses to absorb probable incurred losses.

The first step in determining the allowance for loan losses is to identify loans in the Bank’s portfolio that are individually deemed to be impaired and then measure impairment losses based on either the fair value of collateral or the discounted value of expected future cash flows. In estimating the fair value of real estate collateral, management utilizes appraisals or evaluations adjusted for costs to dispose and a distressed sale adjustment, if needed. Estimating the fair value of collateral other than real estate is also subjective in nature and sometimes requires difficult and complex judgments. Determining expected future cash flows can be more subjective than determining fair values. Expected future cash flows could differ significantly, both in timing and amount, from the cash flows actually received over the loan’s remaining life.

In addition to estimating losses for loans individually deemed to be impaired, management also estimates collective impairment losses for pools of loans that are not specifically reviewed. The Bank's highest average annualized loss experience over periods of 24, 36, 48 or 60 months is generally the starting point in determining its allowance for loan losses for each pool of loans. Management believes that this approach appropriately reflects losses from the current economic cycle and those incurred losses in the Bank's loan portfolio. However, since future losses could vary significantly from those experienced in the past, on a quarterly basis management adjusts its historical loss experience to reflect current conditions. In doing so, management considers a variety of general qualitative factors and then subjectively determines the weight to assign to each in estimating losses. The factors include, among others: (1) delinquencies, (2) economic conditions as judged by things such as median home prices and commercial vacancy rates in the Bank's service area and national and local unemployment levels, (3) trends in the nature and volume of loans, (4) concentrations of credit, (5) changes in lending policies and procedures, (6) experience, ability and depth of lending staff, (7) changes in the quality of the loan review function, (8) environmental risks, and (9) loan risk ratings. Substantially all of the Bank's allowance for loan losses allocable to pools of loans that are collectively evaluated for impairment results from these qualitative adjustments to historical loss experience. Because of the nature of the qualitative factors and the difficulty in assessing their impact, management's resulting estimate of losses may not accurately reflect actual losses in the portfolio.

Although the allowance for loan losses has two separate components, one for impairment losses on individual loans and one for collective impairment losses on pools of loans, the entire allowance for loan losses is available to absorb realized losses as they occur whether they relate to individual loans or pools of loans.

Net Interest Income

Average Balance Sheet; Interest Rates and Interest Differential. The following table sets forth the average daily balances for each major category of assets, liabilities and stockholders' equity as well as the amounts and average rates earned or paid on each major category of interest-earning assets and interest-bearing liabilities. The average balances of investment securities include unrealized gains and losses on available-for-sale securities, and the average balances of loans include nonaccrual loans.

	2016			2015			2014		
	Average Balance	Interest/ Dividends	Average Rate	Average Balance	Interest/ Dividends	Average Rate	Average Balance	Interest/ Dividends	Average Rate
	(dollars in thousands)								
Assets:									
Interest-bearing bank balances	$32,711	$168	.51 %	$20,568	$52	.25 %	$16,675	$36	.22 %
Investment securities:									
Taxable	374,199	7,813	2.09	355,177	7,939	2.24	423,929	9,323	2.20
Nontaxable (1)	465,457	21,056	4.52	438,835	20,902	4.76	414,972	20,628	4.97
Loans (1)	2,364,187	82,469	3.49	1,990,823	70,573	3.54	1,584,198	59,225	3.74
Total interest-earning assets	3,236,554	111,506	3.45	2,805,403	99,466	3.55	2,439,774	89,212	3.66
Allowance for loan losses	(28,238)			(24,531)			(21,554)		
Net interest-earning assets	3,208,316			2,780,872			2,418,220		
Cash and due from banks	30,450			28,665			26,608		
Premises and equipment, net	31,597			29,011			26,429		
Other assets	58,945			59,000			43,846		
	$3,329,308			$2,897,548			$2,515,103		
Liabilities and Stockholders' Equity:									
Savings, NOW and money market deposits	$1,501,096	5,344	.36	$1,159,573	2,564	.22	$972,136	1,955	.20
Time deposits	298,194	5,107	1.71	320,626	5,987	1.87	313,318	6,171	1.97
Total interest-bearing deposits	1,799,290	10,451	.58	1,480,199	8,551	.58	1,285,454	8,126	.63

Short-term borrowings	57,395	296	.52	55,134	183	.33	48,220	148	.31
Long-term debt	375,159	7,255	1.93	364,238	7,795	2.14	299,726	6,774	2.26
Total interest-bearing liabilities	2,231,844	18,002	.81	1,899,571	16,529	.87	1,633,400	15,048	.92
Checking deposits	791,698			735,684			636,718		
Other liabilities	14,960			18,963			20,400		
	3,038,502			2,654,218			2,290,518		
Stockholders' equity	290,806			243,330			224,585		
	$3,329,308			$2,897,548			$2,515,103		
Net interest income (1)		$93,504			$82,937			$74,164	
Net interest spread (1)			2.64 %			2.68 %			2.74 %
Net interest margin (1)			2.89 %			2.96 %			3.04 %

(1) Tax-equivalent basis. Interest income on a tax-equivalent basis includes the additional amount of interest income that would have been earned if the Corporation's investment in tax-exempt loans and investment securities had been made in loans and investment securities subject to Federal income taxes yielding the same after-tax income. The tax-equivalent amount of $1.00 of nontaxable income was $1.54 for each period presented, using the statutory Federal income tax rate of 35%.

Rate/Volume Analysis. The following table sets forth the effect of changes in volumes, rates and rate/volume on tax-equivalent interest income, interest expense and net interest income.

	2016 versus 2015 Increase (decrease) due to changes in:				2015 versus 2014 Increase (decrease) due to changes in:			
	Volume	Rate	Rate/ Volume (1)	Net Change	Volume	Rate	Rate/ Volume (1)	Net Change
	(in thousands)							
Interest Income:								
Interest-bearing bank balances	$31	$54	$ 31	$116	$8	$6	$ 2	$16
Investment securities:								
Taxable	425	(523)	(28)	(126)	(1,512)	153	(25)	(1,384)
Nontaxable	1,268	(1,050)	(64)	154	1,186	(863)	(49)	274
Loans	13,235	(1,128)	(211)	11,896	15,202	(3,067)	(787)	11,348
Total interest income	14,959	(2,647)	(272)	12,040	14,884	(3,771)	(859)	10,254
Interest Expense:								
Savings, NOW & money market deposits	755	1,564	461	2,780	377	195	37	609
Time deposits	(419)	(495)	34	(880)	144	(320)	(8)	(184)
Short-term borrowings	7	102	4	113	21	12	2	35
Long-term debt	234	(751)	(23)	(540)	1,458	(360)	(77)	1,021
Total interest expense	577	420	476	1,473	2,000	(473)	(46)	1,481
Increase (decrease) in net interest income	$14,382	$(3,067)	$ (748)	$10,567	$12,884	$(3,298)	$ (813)	$8,773

(1) Represents the change not solely attributable to change in rate or change in volume but a combination of these two factors. The rate/volume variance could be allocated between the volume and rate variances shown in the table based on the absolute value of each to the total for both.

Net Interest Income – 2016 Versus 2015

Net interest income on a tax-equivalent basis was $93.5 million in 2016, an increase of $10.6 million, or 12.7%, from $82.9 million in 2015. The increase was primarily driven by growth in average interest-earning assets of $431.2 million, or 15.4%, partially offset by a seven basis point decline in net interest margin. Average interest-earning assets grew mostly because of increases in the average balances of loans of $373.4 million, or 18.8%, and securities of $45.6 million, or 5.7%. Although most of the loan growth occurred in mortgage loans, commercial and industrial loans also grew with an increase in average outstandings of $23.5 million, or 27.5%. The Bank's continued ability to grow loans is attributable to a variety of factors including, among others, competitive pricing, targeted solicitation efforts, the introduction of new loan products, advertising campaigns and broker and correspondent relationships for both residential and commercial mortgages.

The growth in loans and securities was primarily funded by growth in the average balances of noninterest-bearing checking deposits of $56.0 million, or 7.6%, interest-bearing deposits of $319.1 million, or 21.6%, and stockholders' equity of $47.5 million, or 19.5%. The Bank's ongoing ability to grow deposits is attributable to, among other things, continued expansion of the Bank's branch distribution system, targeted solicitation of local commercial businesses and municipalities, new and expanded lending relationships, new small business checking and loan products and the expansion of merchant sales relationships. In addition, management believes that the Bank's positive reputation in its marketplace has contributed to both loan and deposit growth. The increase in stockholders' equity is mostly attributable to retained net income and the sale of common stock through an underwritten public offering completed in the second quarter of 2016.

The seven basis point decline in net interest margin was primarily a result of the low rate environment. In a low interest rate environment: (1) loans are sometimes originated and investments are sometimes made at yields lower than existing portfolio yields; (2) some loans prepay in full resulting in the immediate writeoff of deferred costs; (3) prepayment speeds on mortgage-backed securities can be elevated resulting in accelerated amortization of purchase premiums; (4) the benefit of no cost funding in the form of noninterest-bearing checking deposits and capital is suppressed; and (5) the Bank's ability to reduce deposit rates diminishes. The impact of these factors is partially offset in a low rate environment by increased prepayment activity accompanied by higher levels of prepayment penalty income. On a going forward basis, if available yields for loans and securities, prepayment penalties and the cost of deposits and borrowings remain at current levels, net interest margin is not expected to meaningfully decline. This expectation is based on the fact that significant portions of the Bank's mortgage loan and securities portfolios were originated or purchased in a low rate environment at yields similar to those currently available.

Net Interest Income – 2015 Versus 2014

Net interest income on a tax-equivalent basis was $82.9 million in 2015, an increase of $8.8 million, or 11.8%, from $74.2 million in 2014. The increase resulted from an increase in average interest-earning assets of $365.6 million, or 15.0%, as partially offset by an eight basis point decline in net interest margin.

The increase in average interest-earning assets was primarily attributable to growth in the average balances of loans of $406.6 million, or 25.7%, and nontaxable securities of $23.9 million, or 5.8%, partially offset by a decrease in the average balance of taxable securities of $68.8 million, or 16.2%. The growth in the average balance of loans included growth in commercial and industrial loans of $11.3 million, or 14.8%, a large portion of which resulted from the Bank's small business credit scored loan initiative. The growth in loans and nontaxable securities of $406.6 million and $23.9 million, respectively, to the extent not funded by the decline in taxable securities of $68.8 million, was funded by growth in the average balances of noninterest-bearing checking deposits of $99.0 million, or 15.5%, interest-bearing deposits of $194.7 million, or 15.1%, and long-term debt of $64.5 million, or 21.5%.

Intermediate and long-term interest rates remained low and volatile in 2015. Because loans repriced and cash flows were deployed in a low interest rate environment, net interest margin declined from 3.04% in 2014 to 2.96% in 2015. The decline in net interest margin explains why strong growth in the average balance of loans of 25.7% was accompanied by lesser growth of 11.8% in net interest income.

Noninterest Income

Noninterest income includes service charges on deposit accounts, Investment Management Division income, gains or losses on sales of securities, and all other items of income, other than interest, resulting from the business activities of the Corporation.

Noninterest income before securities gains increased $77,000, or 1.0%, when comparing 2016 to 2015. The increase is primarily attributable to proceeds of bank-owned life insurance that exceeded the cash surrender value by $106,000, and increases of $89,000 in service charges on deposit accounts, $76,000 in income from the sale of mutual funds and annuities and $52,000 in cash value accretion on bank-owned life insurance. These increases were partially offset by a $160,000 decrease in real estate tax refunds and a $91,000 sales tax refund in 2015.

Noninterest income before securities gains increased $174,000, or 2.4%, when comparing 2015 to 2014. The increase was primarily attributable to real estate and sales tax refunds of $204,000 and $91,000, respectively, an increase in cash value accretion on bank-owned life insurance of $359,000 and an increase in merchant services income of $76,000. The positive impact of these items was partially offset by a decrease in service charges on deposit accounts of $397,000 resulting largely from a decrease in deposit account overdraft activity in 2015 and a net gain of $165,000 during 2014 on the sale of loans held-for-sale. Cash value accretion increased primarily because of a fourth quarter 2014 purchase of bank-owned life insurance with an initial cash value of $16.9 million. The increase in noninterest income also resulted from debit cards and ATM banking, which produced income of $626,000 in 2015 compared to $583,000 in 2014.

Noninterest Expense

Noninterest expense is comprised of salaries, employee benefits, occupancy and equipment expense and other operating expenses incurred in supporting the various business activities of the Corporation.

Noninterest expense before debt extinguishment costs increased $4.7 million, or 10.4%, when comparing 2016 to 2015. The increase is largely attributable to increases in salaries of $1.4 million, or 6.9%, employee benefits expense of $868,000, or 14.4%, consulting expense of $761,000, occupancy and equipment expense of $466,000, computer and telecommunications expense of $419,000, marketing expense of $175,000 and a partial writedown of $168,000 on the Bank's investment in a trade association. The increase in salaries is primarily due to new branch openings, additions to staff in the back office, higher stock-based compensation expense and normal annual salary adjustments. The increase in employee benefits expense includes a $464,000 increase in group health insurance expense resulting from increases in staff count and the rates being charged by insurance carriers. Employee benefits expense also increased because pension expense was a credit of $489,000 in 2015 versus a charge of $17,000 in 2016. Pension expense increased largely because of an increase in the number of plan participants, a market driven increase in interest on the benefit obligation and the amortization of actuarial losses resulting from, among other things, the return on plan assets falling short of expectation in 2015. The increase in consulting expense is primarily attributable to a one-time charge of $800,000 in the second quarter of 2016 for advisory services rendered in renegotiating the Bank's data processing contract. The Corporation expects that, based on current transaction volumes, the negotiated cost savings will amount to approximately $4.5 to $5.0 million over the seven-year term of the contract. This savings will help to slow the future growth in total operating expenses. The increase in occupancy and equipment expense includes the operating costs of new branches and a growth-related increase in depreciation on the Bank's facilities and equipment. The increase in computer and telecommunications expense is mainly attributable to a growth-related increase in telecommunications capacity and one-time expenses of approximately $126,000 in the second quarter of 2016. The Bank's ongoing investment in and spending on technology and telecommunications-related projects should result in continued enhancement of operating efficiency, business continuity controls and cyber security.

Effective July 1, 2016, the FDIC reduced the assessment rate charged to certain depository institutions, including the Bank, for FDIC insurance coverage. The reduction in the assessment rate lowered the Bank's FDIC insurance cost by approximately $150,000 per quarter commencing in the second half of 2016. The savings resulting from the lower assessment rate is expected to be offset over time by growth-related increases in the assessment base, which is equal to quarterly average total assets less average capital.

Noninterest expense before debt extinguishment costs increased $3.6 million, or 8.5%, when comparing 2015 to 2014. The increase was primarily comprised of an increase in salaries of $1.8 million, or 9.5%, an increase in employee benefits expense of $1.2 million, or 24.6%, a growth-related increase in the combined amount of FDIC insurance expense and the Bank's OCC assessment of $250,000 and a one-time charge of $77,000 resulting from the termination of certain network and communication-related contracts. The impact of these items was partially offset by a decrease in occupancy and equipment expense of $82,000. The increase in salaries was primarily due to new branch openings, additions to staff in the back office and normal annual salary adjustments, partially offset by lower stock-based compensation expense. The decrease in stock-based compensation expense was mainly attributable to the immediate vesting of stock awards granted in the fourth quarter of 2014 with a value of $358,000. The increase in employee benefits expense was largely due to an increase in incentive compensation cost, an increase in payroll tax expense resulting from additions to staff, an increase in group health insurance expense resulting from increases in staff count and the rates being paid for group health insurance and an increase in supplemental executive retirement expense. The decrease in occupancy and equipment expense was primarily attributable to a $453,000 decrease in maintenance and repairs expense, mostly offset by increases in rent, real estate taxes and depreciation of newly-opened branches and expanded back-office space.

Implementation of ASU 2016-09

In the fourth quarter of 2016, the Corporation adopted ASU 2016-09 "Improvements to Employee Share-Based Payment Accounting" effective January 1, 2016. Adoption of the ASU increased 2016 net income through a credit to income tax expense in the amount of $385,000, or $.02 per share. The January 1, 2016 adoption of the ASU increased (decreased) quarterly net income for the first through the fourth quarters of 2016 by $205,000, $109,000, ($13,000) and $84,000, respectively.

Income Taxes

Income tax expense as a percentage of pre-tax book income ("effective tax rate") was 22.7%, 22.4% and 20.9% in 2016, 2015 and 2014, respectively. Among other things, the Corporation's effective tax rate reflects the tax benefits derived from the Bank's municipal securities portfolio, ownership of bank-owned life insurance and maintenance of a captive REIT.

2016 Versus 2015. The Corporation's effective tax rate increased from 22.4% in 2015 to 22.7% in 2016. The increase is primarily attributable to a decline in the percentage of pre-tax book income represented by income on tax-exempt securities, loans and bank-owned life insurance, partially offset by additional funding of the Corporation's captive REIT and the $385,000 credit to income tax expense from the adoption in 2016 of ASU 2016-09. Tax-exempt income as a percentage of pre-tax book income declined from 43.4% in 2015 to 36.7% in 2016 increasing the effective tax rate by 2.2%. Additional funding of the Corporation's captive REIT and the adoption of ASU 2016-09 reduced the effective tax rate by 1.2% and .7%, respectively.

2015 Versus 2014. The Corporation's effective tax rate increased from 20.9% in 2014 to 22.4% in 2015. As discussed hereinafter, this primarily resulted from the combined impact of changes in New York State and New York City income tax laws, a reduction in tax-exempt income as a percentage of pre-tax book income and the progressive nature of the corporate federal income tax.

Effective January 1, 2015, both New York State and New York City substantially revised their income tax law. The New York State banking corporation franchise tax under Article 32 was repealed and banks became subject to a general corporation franchise tax under a substantially revised Article 9A. New York City made conforming changes to their tax law and replaced the bank franchise tax with a new corporate tax contained in subchapter 3-A of chapter 6 of title 11 of New York City's administrative code.

In response to the changes in New York State and New York City income tax laws, the Corporation adjusted its deferred New York State and New York City income tax liability accounts. The adjustment of the New York State deferred tax liability account was made in 2014 and resulted in a one-time net credit to income tax expense of $318,000 and a reduction in the effective tax rate for 2014 of 1.1%. The adjustment of the New York City deferred tax liability account was made in the second quarter of 2015 and resulted in a one-time net charge to income tax expense of $402,000 and an increase in the effective tax rate for 2015 of 1.2%. The timing of these New York State and New York City adjustments was based on the enactment dates of the respective legislation.

Aside from the one-time charges and credits, management estimates that the law changes in combination with additional funding of the Corporation's captive REIT served to reduce the Corporation's 2015 net New York State income tax expense by approximately $875,000 and increase its net New York City income tax expense by approximately $41,000. Together, this resulted in a net decrease in the Corporation's 2015 effective tax rate of 2.5%.

Also impacting the Corporation's effective tax rate in 2015 was a decline in the percentage of pre-tax book income represented by tax-exempt income and the progressive nature of the corporate federal income tax. Income on tax-exempt securities, tax-exempt loans and bank-owned life insurance declined from 48% of pre-tax book income in 2014 to 43.4% in 2015. In addition, in 2015 the Corporation's federal taxable income grew to the point that it was taxed at a 35% rate rather than a portion, as in prior years, being taxed at 34%. These two items together resulted in an increase in the Corporation's 2015 effective tax rate of approximately 2.0%.

Financial Condition

Total assets were $3.5 billion at December 31, 2016, an increase of $380.0 million, or 12.1%, from the previous year-end. The increase was primarily attributable to growth in loans of $297.2 million, or 13.2%, and in available-for-sale securities of $77.6 million, or 10.5%. The growth in loans and securities helped to offset the negative impact of the low interest rate environment on net interest income.

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Asset growth during 2016 was largely funded by growth in deposits and stockholders' equity. Total deposits grew $324.0 million, or 14.2%, to $2.6 billion at December 31, 2016. The growth in deposits is due to increases in savings, NOW and money market deposits of $323.8 million, or 27.1%, and noninterest-bearing checking deposits of $30.3 million, or 3.9%, partially offset by a decrease in time deposits of $30.1 million, or 9.7%.

Investment Securities. The following table presents the estimated fair value of available-for-sale securities and amortized cost of held-to-maturity securities at December 31, 2016, 2015 and 2014.

	2016	2015	2014
		(in thousands)	
Held-to-Maturity Securities:			
State and municipals	$10,419	$ 12,922	$19,836
Pass-through mortgage securities	361	576	856
Collateralized mortgage obligations	607	873	1,141
	$11,387	$ 14,371	$21,833
Available-for-Sale Securities:			
State and municipals	$450,660	$ 435,693	$411,797
Pass-through mortgage securities	185,809	147,265	131,181
Collateralized mortgage obligations	178,830	154,742	231,167
	$815,299	$ 737,700	$774,145

The following table presents the maturities and weighted average yields of the Bank's investment securities at December 31, 2016.

	Principal Maturing (1)							
	Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(dollars in thousands)							
Held-to-Maturity Securities:								
State and municipals (2)	$4,799	5.22 %	$4,732	6.43 %	$888	6.26 %	$-	- %
Pass-through mortgage securities	-	-	-	-	103	9.72	258	5.14
Collateralized mortgage obligations	-	-	-	-	-	-	607	8.03
	$4,799	5.22 %	$4,732	6.43 %	$991	6.62 %	$865	7.17 %
Available-for-Sale Securities: (3)								
State and municipals (2)	$17,046	5.62 %	$77,243	4.87 %	$170,386	4.11 %	$185,985	4.84 %
Pass-through mortgage securities	-	-	-	-	45,469	1.54	140,340	1.83
Collateralized mortgage obligations	-	-	-	-	8,776	2.76	170,054	2.09

$17,046	5.62 %	$77,243	4.87 %	$224,631	3.54 %	$496,379	3.05 %

(1) Maturities shown are stated maturities, except in the case of municipal securities, which are shown at the earlier of their stated maturity or pre-refunded dates. Securities backed by mortgages, which include the pass-through mortgage securities and collateralized mortgage obligations shown above, are expected to have substantial periodic repayments resulting in weighted average lives considerably shorter than would be surmised from the above table.

(2) Yields on tax-exempt municipal securities have been computed on a tax-equivalent basis.

(3) Yields on available-for-sale securities have been computed based on amortized cost.

During 2016, the Bank received cash dividends totaling $1.1 million on its FRB and FHLB stock, representing an average yield of 4.60%.

Loans. The composition of the Bank's loan portfolio is set forth below.

	December 31, 2016	2015	2014	2013	2012
	(in thousands)				
Commercial and industrial	$126,038	$93,056	$77,140	$71,818	$54,339
Commercial mortgages (1):					
Multifamily	610,385	572,322	529,093	469,486	278,503
Other	371,142	348,909	222,537	162,874	141,986
Owner-occupied	103,671	115,100	107,345	83,651	83,879
Residential mortgages:					
Closed end	1,238,431	1,025,215	779,994	605,343	502,367
Revolving home equity	86,461	87,848	83,109	77,581	81,975
Consumer and other	9,293	5,733	5,601	7,184	4,335
	2,545,421	2,248,183	1,804,819	1,477,937	1,147,384
Allowance for loan losses	(30,057)	(27,256)	(23,221)	(20,848)	(18,624)
	$2,515,364	$2,220,927	$1,781,598	$1,457,089	$1,128,760

(1) Certain loans were reclassified within the various classes of the commercial mortgages segment into multifamily at December 31, 2016.

Maturity and rate information for commercial and industrial loans outstanding at December 31, 2016 is set forth below.

	Maturity Within One Year	After One But Within Five Years	After Five Years	Total
	(in thousands)			
Commercial and industrial loans:				
Fixed rate	$604	$20,854	$8,920	$30,378
Variable rate	49,561	35,121	10,978	95,660
	$50,165	$55,975	$19,898	$126,038

Asset Quality. The Corporation has identified certain assets as risk elements. These assets include nonaccrual loans, other real estate owned, loans that are contractually past due 90 days or more as to principal or interest payments and still accruing and troubled debt restructurings. These assets present more than the normal risk that the Corporation will be unable to eventually collect or realize their full carrying value. Information about the Corporation’s risk elements is set forth below.

	December 31, 2016 *(dollars in thousands)*	2015	2014	2013	2012		
Nonaccrual loans (includes loans held-for-sale):							
Troubled debt restructurings	$ 788	$ 900	$ 1,280	$ 2,548	$ 2,430		
Other	1,770	535	424	1,948	1,668		
Total nonaccrual loans	2,558	1,435	1,704	4,496	4,098		
Loans past due 90 days or more and still accruing	621	-	-	-	3,451.8		
Accrued expenses	9.6	1,126.2	543.9	194.3	785.4	—	2,659.4
Current maturities of long-term debt	147.7	1,498.7	—	—	—	—	1,646.4
Total current liabilities	157.3	9,138.6	4,492.7	2,491.5	875.2	—	17,155.3
Long-term debt	11,647.1	497.4	1,801.8	—	—	—	13,946.3
Intercompany	11,648.3	4,022.3	—	—	—	(15,670.6)	—
Deferred taxes	0.2	—	2,833.2	1,442.9	6.1	(212.6)	4,069.8
Other liabilities	—	374.7	288.4	15.9	12.4	—	691.4
Non-controlling interest	—	—	—	—	7.7	—	7.7
Express Scripts stockholders’ equity	17,372.8	7,694.7	33,124.4	19,687.9	1,004.1	(61,511.1)	17,372.8
Total liabilities and stockholders’ equity	$40,825.7	$21,727.7	$42,540.5	$23,638.2	$1,905.5	$(77,394.3)	$53,243.3

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Condensed Consolidating Statement of Operations

(in millions)	Express Scripts Holding Company	Express Scripts, Inc.	Medco Health Solutions, Inc.	Guarantors	Non-Guarantors	Eliminations	Consolidated
For the three months ended March 31, 2016							
Revenues	$—	$9,483.9	$6,318.3	$9,341.5	$ 625.7	$(977.6)	$24,791.8
Operating expenses	—	9,024.4	6,096.2	9,127.4	580.6	(977.6)	23,851.0
Operating income	—	459.5	222.1	214.1	45.1	—	940.8
Other (expense) income:							
Interest (expense) income and other, net	(98.5)	(22.4)	(11.6)	2.2	0.5	—	(129.8)
Intercompany interest income (expense)	64.8	(32.4)	—	(32.4)	—	—	—
Other (expense) income, net	(33.7)	(54.8)	(11.6)	(30.2)	0.5	—	(129.8)
Income (loss) before income taxes	(33.7)	404.7	210.5	183.9	45.6	—	811.0
Provision (benefit) for income taxes	(12.2)	128.2	91.7	76.8	(5.7)	—	278.8
Income (loss) before equity in earnings of subsidiaries	(21.5)	276.5	118.8	107.1	51.3	—	532.2
Equity in earnings (loss) of subsidiaries	547.6	180.0	(27.7)	—	—	(699.9)	—
Net income	526.1	456.5	91.1	107.1	51.3	(699.9)	532.2
Less: Net income attributable to non-controlling interest	—	—	—	—	6.1	—	6.1
Net income attributable to Express Scripts	526.1	456.5	91.1	107.1	45.2	(699.9)	526.1
Other comprehensive income	6.3	6.3	—	—	6.3	(12.6)	6.3
Comprehensive income attributable to Express Scripts	$532.4	$462.8	$91.1	$107.1	$ 51.5	$(712.5)	$532.4
For the three months ended March 31, 2015							
Revenues	$—	$9,678.0	$7,801.1	$7,845.6	$ 606.8	$(1,031.9)	$24,899.6
Operating expenses	—	9,395.5	7,477.1	7,687.8	544.5	(1,031.9)	24,073.0
Operating income	—	282.5	324.0	157.8	62.3	—	826.6
Other (expense) income:							
Interest (expense) income and other, net	(76.0)	(19.2)	(14.5)	0.6	(2.0)	—	(111.1)
Intercompany interest income (expense)	76.0	(38.0)	—	(38.0)	—	—	—
Other expense, net	—	(57.2)	(14.5)	(37.4)	(2.0)	—	(111.1)
Income before income taxes	—	225.3	309.5	120.4	60.3	—	715.5
Provision for income taxes	—	81.9	120.8	63.9	1.8	—	268.4
Income before equity in earnings of subsidiaries	—	143.4	188.7	56.5	58.5	—	447.1
Equity in earnings (loss) of subsidiaries	441.1	231.0	(122.0)	—	—	(550.1)	—
Net income	441.1	374.4	66.7	56.5	58.5	(550.1)	447.1

Less: Net income attributable to non-controlling interest	—	—	—	—	6.0	—	6.0
Net income attributable to Express Scripts	441.1	374.4	66.7	56.5	52.5	(550.1)	441.1
Other comprehensive loss	(8.0)	(8.0)	—	—	(8.0)	16.0	(8.0)
Comprehensive income attributable to Express Scripts	$ 433.1	$ 366.4	$ 66.7	$ 56.5	$ 44.5	$ (534.1)	$ 433.1

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Condensed Consolidating Statements of Cash Flows

(in millions)	Express Scripts Holding Company	Express Scripts, Inc.	Medco Health Solutions, Inc.	Guarantors	Non-Guarantors	Eliminations	Consolidated
For the three months ended March 31, 2016							
Net cash flows provided by (used in) operating activities	$ 14.0	$473.8	$ 83.2	$ 529.7	$ (349.5)	$ —	$ 751.2
Cash flows from investing activities:							
Purchases of property and equipment	—	(60.6)	—	(20.8)	(1.2)	—	(82.6)
Other, net	—	2.3	—	—	0.5	—	2.8
Net cash used in investing activities	—	(58.3)	—	(20.8)	(0.7)	—	(79.8)
Cash flows from financing activities:							
Treasury stock acquired	(3,109.2)	—	—	—	—	—	(3,109.2)
Proceeds from long-term debt, net of discounts	1,991.0	—	—	—	—	—	1,991.0
Repayment of long-term debt	(37.5)	(934.7)	—	—	—	—	(972.2)
Net proceeds from employee stock plans	11.1	—	—	—	—	—	11.1
Excess tax benefit relating to employee stock-based compensation	—	6.1	2.1	—	—	—	8.2
Other, net	(13.0)	(15.0)	—	(3.2)	11.9	—	(19.3)
Net intercompany transactions	1,143.6	(303.8)	(85.8)	(508.9)	(245.1)	—	—
Net cash used in financing activities	(14.0)	(1,247.4)	(83.7)	(512.1)	(233.2)	—	(2,090.4)
Effect of foreign currency translation adjustment	—	—	—	—	3.8	—	3.8
Net decrease in cash and cash equivalents	—	(831.9)	(0.5)	(3.2)	(579.6)	—	(1,415.2)
Cash and cash equivalents at beginning of period	—	1,957.3	2.9	28.8	1,197.3	—	3,186.3
Cash and cash equivalents at end of period	$ —	$1,125.4	$ 2.4	$ 25.6	$ 617.7	$ —	$ 1,771.1

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Condensed Consolidating Statements of Cash Flows

(in millions)	Express Scripts Holding Company	Express Scripts, Inc.	Medco Health Solutions, Inc.	Guarantors	Non-Guarantors	Eliminations	Consolidated
For the three months ended March 31, 2015							
Net cash flows provided by (used in) operating activities	$ 19.9	$ 144.5	$ 49.9	$ 394.5	$ (277.4)	$ (50.0)	$ 281.4
Cash flows from investing activities:							
Purchases of property and equipment	—	(36.0)	—	(11.1)	(1.2)	—	(48.3)
Other, net	—	—	—	—	(19.7)	—	(19.7)
Net cash used in investing activities	—	(36.0)	—	(11.1)	(20.9)	—	(68.0)
Cash flows from financing activities:							
Repayment of long-term debt	(1,210.5)	—	—	—	—	—	(1,210.5)
Net proceeds from employee stock plans	48.8	—	—	—	—	—	48.8
Excess tax benefit relating to employee stock-based compensation	—	12.2	21.6	—	—	—	33.8
Other, net	—	—	—	(5.2)	(53.4)	50.0	(8.6)
Net intercompany transactions	1,141.8	(747.5)	(71.4)	(354.2)	31.3	—	—
Net used in financing activities	(19.9)	(735.3)	(49.8)	(359.4)	(22.1)	50.0	(1,136.5)
Effect of foreign currency translation adjustment	—	—	—	—	(3.7)	—	(3.7)
Net (decrease) increase in cash and cash equivalents	—	(626.8)	0.1	24.0	(324.1)	—	(926.8)
Cash and cash equivalents at beginning of period	—	956.0	0.5	13.7	862.4	—	1,832.6
Cash and cash equivalents at end of period	$ —	$ 329.2	$ 0.6	$ 37.7	$ 538.3	$ —	$ 905.8

Note 11 - Subsequent event

In April 2016, we redeemed the remaining $565.3 million of our $1,500.0 million aggregate principal amount of 3.125% senior notes due 2016. See Note 5 - Financing for further discussion regarding the redemption.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Forward Looking Statements and Associated Risks
Information we have included or incorporated by reference in this Quarterly Report on Form 10-Q, and information which may be contained in our other filings with the Securities and Exchange Commission ("the SEC") and our press releases or other public statements, contains or may contain forward-looking statements. These forward-looking statements include, among other things, statements of our plans, objectives, expectations (financial or otherwise) or intentions.
Our forward-looking statements involve risks and uncertainties. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. We do not undertake any obligation to release publicly any revisions to such forward-looking statements to reflect events or circumstances occurring after the date hereof or to reflect the occurrence of unanticipated events. Any number of factors could cause our actual results to differ materially from those contemplated by any forward-looking statements, including, but not limited to, the risks associated with the following:
STANDARD OPERATING FACTORS

- our ability to remain profitable in a very competitive marketplace depends upon our continued ability to attract and retain clients while maintaining our margins, differentiate our products and services from those of our competitors, and develop and cross-sell new products and services to our existing clients
- our failure to anticipate and appropriately adapt to changes or trends within the rapidly changing healthcare industry
- changes in applicable laws, rules or regulations, or their interpretation or enforcement, or the enactment of new laws, rules or regulations, which apply to our business practices (past, present or future) or require us to spend significant resources for compliance
- a failure in the security or stability of our technology infrastructure, or the infrastructure of one or more of our key vendors
- our failure to execute on, or other issues arising under, certain key client contracts
- significant changes within the pharmacy provider marketplace, including the loss of or adverse change in our relationship with one or more key pharmacy providers
- changes to the healthcare industry designed to manage healthcare costs or alter healthcare financing practices or changes to government policies in general
- a significant failure or disruption in service within our operations or the operations of our vendors
- changes relating to Medicare Part D, our failure to comply with CMS regulatory requirements, our failure to comply with CMS contractual requirements applicable to us as a Medicare Part D PDP sponsor or our failure to otherwise execute on our strategies related to Medicare Part D
- our failure to effectively execute on strategic transactions or successfully integrate the business operations or achieve the anticipated benefits from any acquired businesses
- a failure to adequately protect confidential health information received and used in our business operations
- the termination, loss, or an unfavorable modification, of our relationship with one or more key pharmaceutical manufacturers, or the significant reduction in payments made or discounts provided by pharmaceutical manufacturers
- results in pending and future litigation, investigations or other proceedings which could subject us to significant monetary damages or penalties and/or require us to change our business practices, or the costs incurred in connection with such proceedings
- our failure to attract and retain talented employees, or to manage succession and retention for our Chief Executive Officer or other key executives
- changes in drug pricing or industry pricing benchmarks
- the impact of our debt service obligations on the availability of funds for other business purposes, the terms of and our required compliance with covenants relating to our indebtedness and our access to the credit markets in general

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- the delay, reduction, suspension or cancellation of government spending or appropriations relating to our business
- general economic conditions
- other risks described from time to time in our filings with the SEC

See the more comprehensive description of risk factors under the captions “Forward Looking Statements and Associated Risks” contained in Item 1 - “Business” and Item 1A - “Risk Factors” of our Annual Report on Form 10-K for the year ended December 31, 2015, filed with the SEC on February 16, 2016.

These and other relevant factors and any other information included or incorporated by reference in this Report, and information which may be contained in our other filings with the SEC, should be carefully considered when reviewing any forward-looking statement. We note these factors for investors as permitted under the Private Securities Litigation Reform Act of 1995. Investors should understand it is impossible to predict or identify all such factors or risks. As such, you should not consider either foregoing lists, or the risks identified in our SEC filings, to be a complete discussion of all potential risks or uncertainties.

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OVERVIEW

As the largest stand-alone pharmacy benefit management ("PBM") company in the United States, we provide a full range of services to our clients, which include managed care organizations, health insurers, third-party administrators, employers, union-sponsored benefit plans, workers' compensation plans, government health programs, providers, hospitals and others. We report segments on the basis of products and services offered and have determined we have two reportable segments: PBM and Other Business Operations. Our integrated PBM services include clinical solutions to improve health outcomes, specialized pharmacy care, home delivery pharmacy services, specialty pharmacy services, retail network pharmacy administration, benefit design consultation, drug utilization review, drug formulary management, Medicare, Medicaid and Public Exchange offerings, administration of a group purchasing organization and consumer health and drug information.

Through our Other Business Operations segment, we provide distribution services of specialty pharmaceuticals and medical supplies to providers, clients and hospitals and provide consulting services for pharmaceutical, biotechnology and device manufacturers to collect scientific evidence to guide the safe, effective and affordable use of medicines.

Revenues generated by our segments can be classified as either tangible product revenues or service revenues. We earn tangible product revenues from the sale of prescription drugs by retail pharmacies in our retail pharmacy networks and from dispensing prescription drugs from our home delivery and specialty pharmacies. Service revenues include administrative fees associated with the administration of retail pharmacy networks contracted by certain clients, medication counseling services and certain specialty distribution services. Tangible product revenues generated by our PBM and Other Business Operations segments represented 98.3% and 98.1% of revenues for the three months ended March 31, 2016 and 2015, respectively.

EXECUTIVE SUMMARY AND TREND FACTORS AFFECTING THE BUSINESS

We operate in a dynamic environment influenced by a number of marketplace forces including healthcare reform, increased regulation, macroeconomic factors and competition. We recognize continued consolidation within the broad healthcare sector could shift claims volume within the PBM industry, although the direction and degree of any impact remain unclear. Over the years, our claims volume has been impacted by certain in-group attrition and client losses. We continue to execute our successful business model, which emphasizes the alignment of our financial interests with those of our clients and patients through greater use of generics and lower-cost brands, home delivery and specialty pharmacies. We also continue to benefit from better management of ingredient costs through renegotiation of supplier contracts, increased competition among generic manufacturers and a higher generic fill rate (85.2% for the three months ended March 31, 2016 as compared to 84.3% for the three months ended March 31, 2015, respectively). We have achieved higher generic fill rates as we continue to provide our clients with additional tools designed to proactively manage total drug spend by increasing lower cost alternatives. We expect the ongoing positive trends in our business will continue to offset negative factors.

Revenues related to a large client were realized in the second quarters of each of 2015, 2014 and 2013 due to the structure of the contract. Quarterly performance trends may vary from historical periods as a result of variability, including timing, of our contractual revenue streams.

On March 21, 2016, Anthem filed a lawsuit setting forth certain allegations and claims for relief with respect to our pharmacy benefit management agreement with Anthem (see Part II - Item 1 - Legal Proceedings). We are confident in the strength of our legal position and believe that we have consistently acted in good faith and in accordance with the terms of the agreement and have a number of valid defenses to the claims asserted. We further believe Anthem's lawsuit is without merit. However, litigation and the potential outcome cannot be accurately or effectively predicted and at this time we are unable to provide a timetable or an estimate as to the potential outcome of this matter, some of which could result in a material adverse effect on our business and results of operations. In addition, when we executed our agreement with Anthem in 2009, we considered the overall structure of the agreement and the nature of our relationship with Anthem, including the complexity of the service level required, and attributed a reasonable likelihood of renewal at the end of its term in 2019. Accordingly, we amortized the agreement using a modified pattern of benefit over an estimated useful life of 15 years. However, due to the sequence of recent events regarding our discussions with Anthem, culminating in the filing of the lawsuit on March 21, 2016, we felt it prudent to consider the increased likelihood of either non-renewal or renewal on substantially different terms such that, beginning in

March 2016, we began amortizing our agreement with Anthem over the remaining term of the contract (i.e. using a life of 10 years from the time the agreement was executed in 2009). Previously, we amortized the agreement over 15 years. Therefore, the intangible asset amortization associated with the Anthem agreement will run through the remaining term of the contract at the end of 2019, reducing the previous amortization period by 5 years. This change increases the quarterly intangible asset amortization by approximately $32.0 million and has no impact on EBITDA.

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As the regulatory environment evolves and expands, it is necessary to make significant investments to operate within the regulatory framework and prepare for regulatory changes.

RESULTS OF OPERATIONS

Throughout the description below, reference is made to the impact of generic fill rates. Generally, higher generic fill rates reduce PBM revenues, as generic drugs are generally priced lower than branded drugs. However, as ingredient cost on generic drugs is incrementally lower than the price charged, higher generic fill rates generally have a favorable impact on gross profit.

The home delivery generic fill rate is currently lower than the network generic fill rate as fewer generic substitutions are available among maintenance medications (e.g., therapies for chronic conditions) commonly dispensed from home delivery pharmacies as compared to acute medications which are primarily dispensed by pharmacies in our retail networks.

PBM OPERATING INCOME

	Three Months Ended March 31,	
(in millions)	2016	2015
Product revenues:		
Network revenues(1)	$13,000.6	$14,242.0
Home delivery and specialty revenues(2)	10,611.2	9,626.2
Service revenues	342.2	382.2
Total PBM revenues	23,954.0	24,250.4
Cost of PBM revenues(1)	22,157.3	22,465.9
PBM gross profit	1,796.7	1,784.5
PBM SG&A	874.0	977.2
PBM operating income	$922.7	$807.3
Claims:		
Network	226.1	219.1
Home delivery and specialty(2)	30.2	30.0
Total PBM claims	256.3	249.1
Adjusted network(3)	234.7	219.1
Adjusted home delivery and specialty(2)(3)	88.7	88.3
Total adjusted PBM claims(3)	323.4	307.4

(1) Includes retail pharmacy co-payments of $2,541.0 million and $2,634.3 million for the three months ended March 31, 2016 and 2015, respectively.

(2) Includes home delivery and specialty claims including drugs we distribute to other PBMs' clients under limited distribution contracts with pharmaceutical manufacturers and Freedom Fertility claims.

(3) Includes an adjustment to certain network claims to reflect an approximate 30-day equivalent fill and reflects home delivery claims multiplied by 3, as home delivery claims typically cover a time period 3 times longer than network claims.

PBM revenues. Network pharmacy revenues decreased $1,241.4 million, or 8.7%, in the three months ended March 31, 2016 from 2015. This decrease relates primarily to the expected roll off of certain clients, the renewal of our second largest client, which initially results in lower revenues, better management of supply chain, as well as an increase in the network generic fill rate, partially offset by inflation on branded drugs. Our network generic fill rate increased to 85.9% of network claims in the three months ended March 31, 2016 as compared to 85.1% in 2015.

Home delivery and specialty revenues increased $985.0 million, or 10.2%, in the three months ended March 31, 2016 from 2015. This increase relates primarily to inflation on branded drugs, partially offset by an increase in the home delivery generic fill rate. Our home delivery generic fill rate increased to 79.8% of home delivery claims in the three months ended March 31, 2016 as compared to 78.8% in 2015.

Cost of PBM revenues. Cost of PBM revenues decreased $308.6 million in the three months ended March 31, 2016 from 2015. This decrease is primarily due to the expected roll off of certain clients, the renewal of our second largest client,

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which initially results in lower cost of revenues, the impact of better management of ingredient costs and an increased aggregate generic fill rate, partially offset by inflation on branded drugs.

PBM gross profit. PBM gross profit increased $12.2 million for the three months ended March 31, 2016 from 2015. This increase is primarily due to $54.7 million of transaction and integration costs for the three months ended March 31, 2015, as well as better management of ingredient costs and formulary and cost savings from the increase in the aggregate generic fill rate (85.2% for the three months ended March 31, 2016 as compared to 84.3% in 2015).

PBM selling, general and administrative expense. Selling, general and administrative expense (“SG&A”) for our PBM segment decreased $103.2 million, or 10.6%, for the three months ended March 31, 2016 from 2015. This decrease relates primarily to a $60.0 million legal settlement and $40.9 million of transaction and integration costs for the three months ended March 31, 2015.

PBM operating income. PBM operating income increased $115.4 million, or 14.3%, for the three months ended March 31, 2016 from 2015, based on the various factors described above.

OTHER BUSINESS OPERATIONS OPERATING INCOME

	Three Months Ended March 31,	
(in millions)	2016	2015
Product revenues	$748.0	$570.6
Service revenues	89.8	78.6
Total Other Business Operations revenues	837.8	649.2
Cost of Other Business Operations revenues	787.5	599.7
Other Business Operations gross profit	50.3	49.5
Other Business Operations SG&A	32.2	30.2
Other Business Operations operating income	$18.1	$19.3
Claims:		
Other(1)	0.1	0.2
Total adjusted Other Business Operations claims	0.1	0.2

(1) Includes claims related to drugs distributed through patient assistance programs.

Other Business Operations operating income decreased $1.2 million for the three months ended March 31, 2016 from 2015. The net decrease is due primarily to timing and mix of business across the non-claims producing lines of business.

OTHER (EXPENSE) INCOME, NET

Net other expense increased $18.7 million, or 16.8%, in the three months ended March 31, 2016 from 2015. This increase is primarily due to $6.7 million of costs related to the early repayment of our $1,500.0 million aggregate principal amount of 3.125% senior notes due 2016, as well as increased interest expense related to the 2015 credit agreement (as defined below) and the issuance of $2,000.0 million of senior notes in February 2016. This increase is partially offset by decreased interest expense related to the repayment of various senior notes during both the year ended December 31, 2015 and the three months ended March 31, 2016.

PROVISION FOR INCOME TAXES

Our effective tax rate attributable to Express Scripts decreased to 34.6% for the three months ended March 31, 2016 from 37.8% for the same period in 2015 due to both recurring and discrete events. We believe it is reasonably possible our unrecognized tax benefits could decrease by approximately $30.0 million within the next twelve months due to the conclusion of various examinations as well as lapses in various statutes of limitations.

We recognized net discrete benefits of $19.7 million for the three months ended March 31, 2016, compared to net discrete charges of $2.3 million for the same period in 2015. Our 2016 net discrete benefits and our 2015 net discrete charges primarily relate to changes in our unrecognized tax benefits.

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We are currently pursuing an approximate $531.0 million potential tax benefit related to the disposition of PolyMedica Corporation (Liberty). No net benefit has been recognized. A net benefit may become realizable in the future; however we cannot predict with any certainty the amount or timing of realization.

NET INCOME ATTRIBUTABLE TO NON-CONTROLLING INTEREST

Net income attributable to non-controlling interest represents the share of net income allocated to members in our consolidated affiliates. These amounts are directly impacted by the profitability of our consolidated affiliates.

NET INCOME AND EARNINGS PER SHARE ATTRIBUTABLE TO EXPRESS SCRIPTS

Net income attributable to Express Scripts for the three months ended March 31, 2016 increased $85.0 million, or 19.3%, from 2015 due to the factors described above.

Basic and diluted earnings per share attributable to Express Scripts increased 34.4% and 35.0%, respectively, for the three months ended March 31, 2016 from 2015. These increases are primarily due to reduced shares outstanding (a total of 223.3 million shares held in treasury on March 31, 2016, compared to 122.5 million shares held in treasury on March 31, 2015), as well as higher operating income.

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ADJUSTED EBITDA ATTRIBUTABLE TO EXPRESS SCRIPTS

Provided below is a reconciliation of net income attributable to Express Scripts to each of EBITDA attributable to Express Scripts ("EBITDA") and adjusted EBITDA attributable to Express Scripts ("Adjusted EBITDA"), as we believe it is the most directly comparable measure calculated under accounting principles generally accepted in the United States:

EBITDA[(1)]	Three Months Ended March 31,	
(in millions, except per claim data)	2016	2015
Net income attributable to Express Scripts	$526.1	$441.1
Provision for income taxes	278.8	268.4
Depreciation and amortization[(2)]	525.3	556.7
Other expense, net	129.8	111.1
EBITDA[(1)]	1,460.0	1,377.3
Adjustments to EBITDA		
Transaction and integration costs[(2)]	—	74.8
Legal settlement	—	60.0
EBITDA/Adjusted EBITDA[(3)]	1,460.0	1,512.1
Total adjusted claims[(4)]	323.5	307.6
EBITDA/Adjusted EBITDA per adjusted claim[(5)]	$4.51	$4.92

(1) EBITDA is earnings before income taxes, depreciation and amortization and other expense. EBITDA is presented because it is a widely accepted indicator of a company's ability to service indebtedness and is frequently used to evaluate a company's performance. EBITDA, however, should not be considered as an alternative to net income, as a measure of operating performance, as an alternative to cash flow, as a measure of liquidity or as a substitute for any other measure computed in accordance with accounting principles generally accepted in the United States. In addition, our definition and calculation of EBITDA may not be comparable to that used by other companies.

(2) Depreciation and amortization for the three months ended March 31, 2016 includes an additional $10.5 million related to our decision to amortize our pharmacy benefit management agreement with Anthem over 10 years as opposed to 15 years. See Note 3 - Goodwill and other intangible assets for additional details. Depreciation and amortization presented above includes $20.8 million for the three months ended March 31, 2015 of depreciation related to the integration of Medco Health Solutions, Inc. ("Medco") which is not included in transaction and integration costs.

(3) Adjusted EBITDA is a supplemental measurement used by analysts and investors to help evaluate overall operating performance. We have calculated Adjusted EBITDA excluding transaction and integration costs recorded each year and a legal settlement as these charges are not considered an indicator of ongoing company performance.

(4) Includes an adjustment to certain network claims to reflect an approximate 30-day equivalent fill and reflects home delivery claims multiplied by 3, as home delivery claims typically cover a time period 3 times longer than network claims.

(5) EBITDA per adjusted claim and Adjusted EBITDA per adjusted claim is calculated by dividing EBITDA and Adjusted EBITDA, as applicable, by the adjusted claim volume for the period. This measure is used as an indicator of EBITDA and Adjusted EBITDA, as applicable, performance on a per unit basis. EBITDA and Adjusted EBITDA, as applicable, and, as a result, EBITDA and Adjusted EBITDA, as applicable, per adjusted claim, are each affected by the changes in claims volume between retail and home delivery and the relative representation of brand-name, generic and specialty pharmacy drugs, as well as the level of efficiency in the business.

The anticipated lower EBITDA and EBITDA per adjusted claim relative to the first quarter of 2015 is primarily a result of: (i) the expected transition of a certain client (as a result of acquisition) at the end of 2015 and into 2016, of which the primary services provided were formulary management and manufacturer rebate services with no associated claims; (ii) the expected roll off of a certain client (as a result of acquisition) on January 1, 2016; and (iii) with respect to EBITDA per adjusted claim, the renewal of our second largest client beginning in May 2015, which initially results in lower EBITDA per adjusted claim.

LIQUIDITY AND CAPITAL RESOURCES
OPERATING CASH FLOW AND CAPITAL EXPENDITURES
In the three months ended March 31, 2016, net cash provided by operating activities increased $469.8 million to $751.2 million, due partially to an increase in net income of $85.1 million in 2016 from 2015. In addition, changes in working capital resulted in a cash outflow of $217.7 million in 2016 compared to a cash outflow of $602.9 million in 2015, resulting in a total change of $385.2 million.
In the three months ended March 31, 2016, net cash used in investing activities increased $11.8 million to $79.8 million. Capital expenditures for purchases of property and equipment increased $34.3 million in 2016 from 2015. We intend to continue to invest in infrastructure and technology we believe will provide efficiencies in operations, facilitate growth and enhance the services we provide to our clients. Anticipated capital expenditures are expected to be funded primarily from operating cash flow or, to the extent necessary, with borrowings under our available credit sources, described below.
In the three months ended March 31, 2016, net cash used in financing activities increased $953.9 million to $2,090.4 million. Cash outflows for 2016 include $3,109.2 million of treasury share repurchases and $972.2 million related to the repayment of debt, compared to outflows during the same period of 2015 of $1,210.5 million related to the repayment of debt. Cash inflows for 2016 include $1,991.0 million related to the February 2016 Senior Notes (defined below).
We anticipate our current cash balances, cash flows from operations and our available credit sources will be sufficient to meet our cash needs and make scheduled payments for our contractual obligations and current capital commitments. However, if needs arise, we may decide to secure external capital to provide additional liquidity. New sources of liquidity may include additional lines of credit, term loans, or issuance of notes or equity, all of which are allowable, with certain limitations, under our credit agreements and other debt instruments. While our ability to secure debt financing in the short term at rates favorable to us may be moderated due to various factors, including existing debt levels, market conditions or other factors, we believe our liquidity options described above are sufficient to meet our anticipated cash flow needs.
ACQUISITIONS AND RELATED TRANSACTIONS
We regularly review potential acquisitions and affiliation opportunities. We believe available cash resources, bank financing or the issuance of debt or equity could be used to finance future acquisitions or affiliations. There can be no assurance we will enter into new acquisitions or establish new affiliations in the future.
SHARE REPURCHASE PROGRAM
In January 2016, we settled the $5,500.0 million accelerated share repurchase agreement executed in April 2015 (the “2015 ASR Agreement”) and received 9.1 million additional shares, resulting in a total of 64.2 million shares received under the 2015 ASR Agreement. The $825.0 million that had previously been recorded in additional paid-in capital in respect of the 2015 ASR Agreement was reclassified to treasury stock upon settlement of the 2015 ASR Agreement.
In February 2016, we entered into an accelerated share repurchase agreement (the “2016 ASR Agreement”) to repurchase shares of our common stock for an initial payment of $2,800.0 million. We recorded an increase to treasury stock of $2,240.0 million and a decrease to additional paid-in capital of $560.0 million in the unaudited consolidated balance sheet. See Note 6 - Common stock for additional details.
Including the shares initially delivered under the 2016 ASR Agreement and upon the settlement of the 2015 ASR Agreement, we repurchased 45.7 million shares under our share repurchase program for $3,374.2 million during the three months ended March 31, 2016. There were no repurchases during the three months ended March 31, 2015. As of March 31, 2016, there were 42.9 million shares remaining under our share repurchase program. Additional share repurchases, if any, will be made in such amounts and at such times as we deem appropriate based upon prevailing market and business conditions and other factors.
BANK CREDIT FACILITIES
In April 2015, we entered into a credit agreement (the “2015 credit agreement”) providing for a five-year $2,000.0 million revolving credit facility (the “2015 revolving facility”), a two-year $2,500.0 million term loan (the “2015 two-year term loan”) and a five-year $3,000.0 million term loan (the “2015 five-year term loan”). At March 31, 2016, no amounts were outstanding under the 2015 revolving facility. We make quarterly principal payments on the 2015

five-year term loan. At March 31, 2016, $150.0 million of the 2015 credit agreement, and a proportionate amount of unamortized financing costs, was considered current maturities of long-term debt. See Note 5 - Financing for additional details.

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In August 2015, we entered into a one-year credit agreement, providing for an uncommitted $150.0 million revolving credit facility (the “2015 credit facility”). In December 2014, we entered into a one-year credit agreement, providing for an uncommitted $150.0 million revolving credit facility (the “2014 credit facility”). In October 2015, an amendment was executed to extend the 2014 credit facility’s termination date to April 2016 and to decrease the 2014 credit facility to $130.0 million. At March 31, 2016, no amounts were drawn under the 2015 credit facility or the 2014 credit facility.

SENIOR NOTES

During both March and April 2016, $1,500.0 million aggregate principal amount of 3.125% senior notes due 2016 were repaid.

In February 2016, we issued senior notes (the “February 2016 Senior Notes”) consisting of:

- $500.0 million aggregate principal amount of 3.300% senior notes due 2021
- $1,500.0 million aggregate principal amount of 4.500% senior notes due 2026

We used the net proceeds from the sale of the February 2016 Senior Notes to complete a tender offer and follow-on redemption of our 3.125% senior notes due 2016 (which were fully redeemed by April 2016), to enter into an accelerated share repurchase program and for other general corporate purposes.

Our bank financing arrangements and senior notes contain certain customary covenants that restrict our ability to incur additional indebtedness, create or permit liens on assets and engage in mergers or consolidations. The covenants related to bank financing arrangements also include, among other things, a maximum leverage ratio. The 7.125% senior notes due 2018 issued by Medco are also subject to an interest rate adjustment in the event of a downgrade in our credit ratings to below investment grade. At March 31, 2016, we were in compliance with all covenants associated with our debt instruments.

IMPACT OF INFLATION

Most of our contracts provide we bill clients based on a generally recognized price index for pharmaceuticals and accordingly, the rate of inflation, and our efforts to manage the impact of inflation for our clients, with respect to prescription drugs can affect our revenues and cost of revenues.

OTHER MATTERS

In March 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends Accounting Standards Codification (“ASC”) Topic 718, Compensation – Stock Compensation. The new standard simplifies the accounting for stock-based compensation, including amendments on how both taxes related to stock-based compensation and cash payments made to taxing authorities are recorded. These amendments are expected to impact net income, earnings per share (“EPS”) and the consolidated statement of cash flows. The new guidance is effective for financial statements issued for annual reporting periods beginning after December 15, 2016, and early application is permitted, with any adjustments reflected as of the beginning of the fiscal year of adoption. We are currently evaluating the impact of this standard on our consolidated financial statements.

In February 2016, FASB issued ASU 2016-02, Leases (ASC Topic 842), which supersedes ASC Topic 840, Leases. This ASU is intended to increase transparency and comparability of organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The new guidance is effective for financial statements issued for annual reporting periods beginning after December 15, 2018, and early application is permitted. We are currently evaluating the impact of this standard on our consolidated financial statements.

In May 2014, FASB issued ASU 2014-09, Revenue from Contracts with Customers (ASC Topic 606), which supersedes ASC Topic 605, Revenue Recognition. The new standard requires companies to recognize revenues upon transfer of goods or services to customers in amounts that reflect the consideration which the company expects to receive in exchange for those goods or services. In July 2015, the FASB delayed the effective date of the standard by one year. The new guidance is effective for financial statements issued for annual reporting periods beginning after December 15, 2017, and early application is not permitted before the original effective date of annual reporting periods beginning after December 15, 2016. We are currently evaluating the impact of this standard on our consolidated financial statements.

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CLIENTS

We are a provider of services to managed care organizations, health insurers, third-party administrators, employers, union-sponsored benefit plans, workers' compensation plans, government health programs, providers, clinics, hospitals and others. Refer to Note 9 - Segment information for a description of client concentration.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Our estimates and assumptions are based upon a combination of historical information and various other assumptions believed to be reasonable under the particular circumstances. Actual results may differ from our estimates. For a description of our critical accounting policies, please refer to "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies" included in our Annual Report on Form 10-K filed with the SEC on February 16, 2016.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from changes in interest rates related to variable rate debt outstanding under the 2015 credit agreement. Our earnings are subject to change as a result of movements in market interest rates. At March 31, 2016, we had $4,887.5 million of gross obligations under our 2015 credit agreement which were subject to variable rates of interest. A hypothetical increase in interest rates of 1% would result in an increase in annual interest expense of approximately $48.9 million (pre-tax), assuming obligations subject to variable interest rates remained constant.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 ("Exchange Act")) designed to provide reasonable assurance that information required to be disclosed in our filings under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon this evaluation, the Chief Executive Officer and the Chief Financial Officer concluded the design and operation of these disclosure controls and procedures are effective in providing reasonable assurance of the achievement of the objectives described above.

During the quarter ended March 31, 2016, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We and/or our subsidiaries are defendants in a number of lawsuits. We cannot ascertain with any certainty at this time the monetary damages or injunctive relief that any of the plaintiffs may recover. We also cannot provide any assurance the outcome of any of these matters, or some number of them in the aggregate, will not be materially adverse to our financial condition, results of operations, cash flows or business prospects. In addition, the expenses of defending these cases may have a material adverse effect on our financial results.

The following descriptions have been updated since the filing of our Annual Report on Form 10-K for the year ended December 31, 2015, relating to proceedings involving the Company:

- United States of America ex. rel. Shane Lager v. CSL Behring, LLC, CSL Limited, Accredo Health, Inc., and Coram LLC (United States District Court for the Eastern District of Missouri) (unsealed February 2015). This is a qui tam lawsuit in which the United States government has declined to intervene against any of the defendants. Lager, the qui tam relator, served a complaint on the Company on June 23, 2015. Lager alleges claims under the federal False Claims Act. The allegations asserted primarily concern an alleged conspiracy among the defendants to inflate the published average wholesale price (“AWP”) of certain drugs and submit them for payment by the federal government. Lager generally alleges that Accredo was aware of the alleged AWP inflation and submitted false claims to the government by failing to disclose the alleged AWP inflation to their government health care program clients in violation of the False Claims Act. The complaint seeks monetary damages, as well as costs and expenses. On August 21, 2015, the Company filed a motion to dismiss the complaint under the public disclosure bar, for failure to state a claim, and for failure to plead fraud with particularity. Relator filed a response to the motion on October 21, 2015 and the Company filed a reply on November 12, 2015. On January 20, 2016, the Court granted the Company’s motion, as well as motions filed by the other defendants, and the case was dismissed with prejudice. Lager appealed the Court’s ruling and filed his opening Appellant’s Brief on April 18, 2016.
- Anthem, Inc. v. Express Scripts, Inc. (United States District Court for the Southern District of New York) (filed March 21, 2016). Anthem filed this lawsuit alleging various breach of contract claims against ESI relating to the parties’ rights and obligations under the periodic pricing review section of the pharmacy benefit management agreement between the parties, including allegations that ESI failed to negotiate new pricing concessions in good faith, as well as various alleged service issues. Anthem requests the court enter declaratory judgment that ESI is required to provide Anthem competitive benchmark pricing, that Anthem can terminate the agreement, and that ESI is required to provide Anthem with post-termination services at competitive benchmark pricing for one year following any termination by Anthem. Anthem claims it is entitled to $13,000.0 million in additional pricing concessions over the remaining term of the agreement as well as $1,800.0 million for one year following any contract termination by Anthem, and $150.0 million in damages for service issues. On April 19, 2016, in response to Anthem’s complaint, ESI filed its answer denying Anthem’s allegations in their entirety and asserting affirmative defenses and counterclaims against Anthem. Among other things, ESI counterclaims that: (1) Anthem breached the agreement by failing to negotiate in good faith with respect to its own proposed new pricing terms; (2) Anthem breached the implied covenant of good faith and fair dealing under the agreement by disregarding the terms of the transaction in which it negotiated and accepted a $4,675.0 million cash payment in 2009; (3) ESI is entitled to a declaratory judgment that Anthem does not have a contractual right to any change in pricing under the agreement, that ESI has no contractual obligation to ensure that Anthem is receiving any specific level of pricing, and that ESI’s sole obligation is to negotiate in good faith over any pricing terms proposed by Anthem; (4) ESI is entitled to a declaratory judgment regarding the timing of when the periodic pricing review ripened under the agreement, such that the process begins on the dates provided in the agreement; (5) ESI is entitled to a declaratory judgment that Anthem does not have the right to terminate the agreement; and (6) in the alternative, Anthem has been unjustly enriched by the $4,675.0 million payment.

Investigations under the federal False Claims Act and most state false claims acts may be initiated by the applicable government investigative body or by a qui tam relator’s filing of a complaint under court seal. If a qui tam relator’s complaint remained under seal, applicable law would restrict our ability to disclose such a fact.

In addition to the foregoing matters there have arisen various legal proceedings, investigations or claims in the ordinary course of our business now pending against us or our subsidiaries. The effect of these actions on future financial results is not subject to reasonable estimation because the proceedings are in early stages and/or considerable uncertainty exists about the outcomes. Where insurance coverage is not available for such claims, or in our judgment, is not cost-effective, we maintain self-insurance accruals to reduce our exposure to future legal costs, settlements and judgments related to uninsured claims. Our self-insured accruals are based upon estimates of the aggregate liability for the costs of uninsured claims incurred and the retained portion of insured claims using certain actuarial assumptions followed in the insurance industry and our experience. It is not possible to predict with certainty the outcome of these claims, and we can give no assurance that any losses in excess of our insurance and any self-insurance accruals will not be material.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following is a summary of our stock repurchasing activity during the three months ended March 31, 2016 (share data in millions):

Period	Total number of shares purchased	Average price paid per share		Total number of shares purchased as part of a publicly announced program	Maximum number of shares that may yet be purchased under the program[(1)]
1/1/2016 - 1/31/2016	9.1	$ —	(2)	9.1	79.5
2/1/2016 - 2/29/2016	35.4	69.62	(3)	35.4	44.1
3/1/2016 - 3/31/2016	1.2	70.64		1.2	42.9
First Quarter 2016 Total	45.7	$ 69.65	(2)(3)	45.7	

(1) Excludes the effect of the anticipated settlement of the 2016 ASR Program.

(2) Average price paid per share excludes the effect of the 9.1 million shares that were delivered upon the settlement of the 2015 ASR Agreement in January 2016. These shares are included in the total number of shares purchased in January 2016 and reduce the remaining shares available to be purchased under the share repurchase program.

(3) Includes the average price paid per share for the 32.1 million shares received in February 2016 under the 2016 ASR Program. The final average price per share paid for the shares will be determined based on the forward price determined in accordance with the 2016 ASR Agreement. See Note 6 - Common stock for further information regarding the 2016 ASR Agreement.

The repurchases disclosed in this table were made pursuant to the share repurchase program, originally announced in 2013. As of March 31, 2016, there were 42.9 million shares remaining under the share repurchase program. Additional share repurchases, if any, will be made in such amounts and at such times as we deem appropriate based upon prevailing market and business conditions and other factors.

Item 6. Exhibits

(a) See Index to Exhibits below.

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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.

		EXPRESS SCRIPTS HOLDING COMPANY (Registrant)
Date: April 25, 2016	By:	/s/ George Paz George Paz, Chairman and Chief Executive Officer
Date: April 25, 2016	By:	/s/ Eric Slusser Eric Slusser, Executive Vice President and Chief Financial Officer

INDEX TO EXHIBITS
(Express Scripts Holding Company – Commission File Number 1-35490)

Exhibit Number	Exhibit
2.1[(2)]	Agreement and Plan of Merger, dated as of July 20, 2011, by and among Express Scripts, Inc., Medco Health Solutions, Inc., Aristotle Holding, Inc., Aristotle Merger Sub, Inc. and Plato Merger Sub, Inc., incorporated by reference to Exhibit 2.1 to Express Scripts, Inc.'s Current Report on Form 8-K filed July 22, 2011, File No. 000-20199.
2.2	Amendment No. 1 to Agreement and Plan of Merger, dated as of November 7, 2011, by and among Express Scripts, Inc., Medco Health Solutions, Inc., Aristotle Holding, Inc., Aristotle Merger Sub, Inc., and Plato Merger Sub, Inc., incorporated by reference to Exhibit 2.1 to Express Scripts, Inc.'s Current Report on Form 8-K filed November 8, 2011, File No. 000-20199.
3.1	Amended and Restated Certificate of Incorporation of the Company, incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed April 2, 2012.
3.2	Amended and Restated Bylaws of the Company, as amended on March 9, 2016, incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed March 10, 2016.
4.1	Sixteenth Supplemental Indenture, dated as of February 25, 2016, among the Company, the Subsidiary Guarantors party thereto and Wells Fargo Bank, National Association, as Trustee, incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed February 25, 2016.
4.2	Seventeenth Supplemental Indenture, dated as of February 25, 2016, among the Company, the Subsidiary Guarantors party thereto and Wells Fargo Bank, National Association, as Trustee, incorporated by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K filed February 25, 2016.
10.1[(3)]	Confirmation – Accelerated Share Repurchase Transaction, dated February 25, 2016, between the Company and Morgan Stanley & Co. LLC, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed February 26, 2016.
11.1	Statement regarding computation of earnings per share. (See Note 4 to the unaudited consolidated financial statements.)
31.1[(1)]	Certification by George Paz, as Chairman and Chief Executive Officer of Express Scripts Holding Company, pursuant to Exchange Act Rule 13a-14(a).
31.2[(1)]	Certification by Eric Slusser, as Executive Vice President and Chief Financial Officer of Express Scripts Holding Company, pursuant to Exchange Act Rule 13a-14(a).
32.1[(1)]	Certification by George Paz, as Chairman and Chief Executive Officer of Express Scripts Holding Company, pursuant to 18 U.S.C. § 1350 and Exchange Act Rule 13a-14(b).
32.2[(1)]	Certification by Eric Slusser, as Executive Vice President and Chief Financial Officer of Express Scripts Holding Company, pursuant to 18 U.S.C. § 1350 and Exchange Act Rule 13a-14(b).
101.INS[(1)]	XBRL Taxonomy Instance Document.

101.SCH[1]	XBRL Taxonomy Extension Schema Document.
101.CAL[1]	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF[1]	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB[1]	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE[1]	XBRL Taxonomy Extension Presentation Linkbase Document.

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1 Filed herein.

2 The Merger Agreement listed in Exhibit 2.1 (the “Agreement”) is not intended to modify or supplement any factual disclosures about the parties thereto, including the Company, and should not be relied upon as disclosure about such parties without consideration of the periodic and current reports and statements that the parties thereto file with the SEC. The terms of the Agreement govern the contractual rights and relationships, and allocate risks, among the parties in relation to the transactions contemplated by the Agreement. In particular, the representations and warranties made by the parties in the Agreement reflect negotiations between, and are solely for the benefit of, the parties thereto and may be limited or modified by a variety of factors, including: subsequent events, information included in public filings, disclosures made during negotiations, correspondence between the parties and disclosure schedules and disclosure letters, as applicable, to the Agreement. Accordingly, the representations and warranties may not describe the actual state of affairs at the date they were made or at any other time and you should not rely on them as statements of fact. In addition, the representations and warranties made by the parties in the Agreement may be subject to standards of materiality applicable to the contracting parties that differ from those applicable to investors. The schedules to the Agreement have been omitted pursuant to Item 601(b)(2) of Regulation S-K and will be furnished supplementally to the SEC upon request.

3 Certain portions of this exhibit have been omitted and filed separately with the SEC pursuant to a confidential treatment order of the SEC.