

FIRST RELIANCE BANCSHARES INC
Form 10-K
March 29, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended December 31, 2011

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 000-49757

FIRST RELIANCE BANCSHARES, INC.

(Exact Name of Registrant as Specified in its Charter)

South Carolina 80-0030931
(State of Incorporation) (I.R.S. Employer Identification No.)

2170 W. Palmetto Street, Florence, South Carolina 29501
(Address of Principal Executive Offices) (Zip Code)
(843) 656-5000

(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

None

Securities Registered Pursuant to Section 12(g) of the Act:

Common Stock, \$0.01 Par Value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes No

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 and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 No

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 of this chapter) 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 "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer 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 Exchange Act). Yes No

The aggregate market value of the registrant's outstanding common stock held by nonaffiliates of the registrant as of June 30, 2011 was approximately \$7.4 million, based on the registrant's closing sales price of \$1.80 as reported on the Over-the Counter Bulletin Board on June 30, 2011. There were 4,084,400 shares of the registrant's common stock outstanding as of March 6, 2012.

DOCUMENTS INCORPORATED BY REFERENCE

Document	Parts Into Which Incorporated
Annual Report to Shareholders for the Year Ended December 31, 2011	Part II
Proxy Statement for the Annual Meeting of Shareholders to be held June 21, 2012	Part III

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of our statements contained in this Annual Report, including, without limitation, matters discussed under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operation,” are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements relate to future events or the future financial performance of First Reliance Bancshares, Inc. (the “Company”) or its wholly-owned subsidiary, First Reliance Bank (the “Bank” or “First Reliance”), and include statements about the competitiveness of the banking industry, potential regulatory obligations, our entrance and expansion into other markets, our other business strategies and other statements that are not historical facts. Forward-looking statements are not guarantees of performance or results. When we use words like “may,” “plan,” “contemplate,” “anticipate,” “believe,” “intend,” “continue,” “expect,” “project,” “predict,” “estimate,” “could,” “should,” “would,” “will,” and similar expressions, you should identify them as identifying forward-looking statements, although we may use other phrasing. These forward-looking statements involve risks and uncertainties and are based on our beliefs and assumptions, and on the information available to us at the time that these disclosures were prepared.

These forward-looking statements involve risks and uncertainties and may not be realized due to a variety of factors, including, but not limited to the following:

deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses;

- changes in loan underwriting, credit review or loss reserve policies associated with economic conditions, examination conclusions, or regulatory developments;
- the failure of assumptions underlying the establishment of reserves for possible loan losses;

changes in political and economic conditions, including the political and economic effects of the current economic downturn and other major developments, including the ongoing war on terrorism, continued tensions in the Middle East, and the ongoing economic challenges facing the European Union;

changes in financial market conditions, either internationally, nationally or locally in areas in which the Company conducts its operations, including, without limitation, reduced rates of business formation and growth, commercial and residential real estate development, and real estate prices;

the Company’s ability to comply with any requirements imposed on it or the Bank by their respective regulators, and the potential negative consequences that may result;

fluctuations in markets for equity, fixed-income, commercial paper and other securities, which could affect availability, market liquidity levels, and pricing;

- governmental monetary and fiscal policies, as well as legislative and regulatory changes;

the Company's participation or lack of participation in governmental programs implemented under the Emergency Economic Stabilization Act (the "EESA") and the American Recovery and Reinvestment Act (the "ARRA"), including, without limitation, the Capital Purchase Program ("CPP") administered under the Troubled Asset Relief Program ("TARP"), and the Temporary Liquidity Guarantee Program (the "TLGP") and the impact of such programs and related regulations on the Company and on international, national, and local economic and financial markets and conditions;

the Company's lack of participation in a "stress test" under the Federal Reserve's Supervisory Capital Assessment Program; the diagnostic and stress testing we conducted differs from that administered under the Supervisory Capital Assessment Program, and the results of our test may be inaccurate;

the impact of the EESA and the ARRA and related rules and regulations on the business operations and competitiveness of the Company and other participating American financial institutions, including the impact of the executive compensation limits of these acts, which may impact the ability of the Company to retain and recruit executives and other personnel necessary for their businesses and competitiveness;

the risks of changes in interest rates on the level and composition of deposits, loan demand and the values of loan collateral, securities and interest sensitive assets and liabilities;

the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone and the Internet; and

the effect of any mergers, acquisitions or other transactions, to which we or our subsidiary may from time to time be a party, including, without limitation, our ability to successfully integrate any businesses that we acquire.

Many of these risks are beyond our ability to control or predict, and you are cautioned not to put undue reliance on such forward-looking statements. First Reliance does not intend to update or reissue any forward-looking statements contained in this Annual Report as a result of new information or other circumstances that may become known to the Company.

All written or oral forward-looking statements attributable to us are expressly qualified in their entirety by this Cautionary Note. Our actual results may differ significantly from those we discuss in these forward-looking statements.

For other factors, risks and uncertainties that could cause our actual results to differ materially from estimates and projections contained in these forward-looking statements, please read the “Risk Factors” section of this Annual Report beginning on page 23.

PART I

ITEM 1. BUSINESS

General

The Company was incorporated under the laws of the State of South Carolina on April 12, 2001 to be the holding company for the Bank, and the Company acquired all of the shares of the Bank on April 1, 2002 in a statutory share exchange. The Bank, a South Carolina banking corporation, is the Company’s only subsidiary, and the Company conducts no business other than through its ownership of the Bank. The Company has no indirect subsidiaries or special purpose entities. The Bank commenced operations in August 1999 and currently operates out of its main office and five branch offices. The Bank serves the Florence, Lexington, Charleston, and West Columbia areas in South Carolina as an independent, community-oriented commercial bank emphasizing high-quality, responsive and personalized service. The Bank provides a broad range of consumer and business banking services, concentrating on individuals and small and medium-sized businesses desiring a high level of personalized services.

The Company’s stock is traded on the OTC Bulletin Board under the symbol “FSRL.” Information about the Company is available on our website at www.firstreliance.com. Information on the Company’s website is not incorporated by reference and is not a part of this Report.

Location and Service Area

The executive or main office facilities of the Company and the Bank are located at 2170 W. Palmetto Street, Florence, South Carolina 29501. The Bank also has branches located at 411 Second Loop Road, Florence, South Carolina; 801 North Lake Drive, Lexington, South Carolina; 800 South Shelmore Boulevard, Mount Pleasant, South Carolina; 25 Cumberland Street, Suite 101, Charleston, South Carolina; and 2805A Sunset Boulevard, West Columbia, South Carolina. The Bank's primary market areas are the cities of Florence, Lexington, West Columbia, and Charleston, and the surrounding areas.

According to United States Census Bureau estimates, in 2010, Florence County had an estimated population of 136,885. Florence County, which covers approximately 805 square miles, is located in the eastern portion of South Carolina and is bordered by Darlington, Marlboro, Dillon, Williamsburg, Marion, Clarendon, Sumter, and Lee Counties. Florence County has a number of large employers, including, GE Healthcare, Honda, Nan Ya Plastics, ESAB, QVC US, Monster.com, McLeod Regional Medical Center, and Carolinas Medical Center. The principal components of the economy of Florence County are the wholesale and retail trade sector, the manufacturing sector, the services sector and the financial, insurance and real estate sector.

According to the United States Census Bureau, Lexington County had an estimated population in 2010 of 262,391. The primary market area is the City of Lexington and the surrounding areas of Lexington County, South Carolina. Lexington County is centrally located in the Midlands of South Carolina just outside the capital city in Columbia and is bordered by Richland, Newberry, Saluda, Aiken, Orangeburg, and Calhoun Counties. Lexington County has a number of large employers, including, Westinghouse Electric Corporation, Michelin North America, Winnsboro Assembly Opera, Amick Farms, Inc., and Bose Corporation. Lexington County is a major transportation crossroads for the Midlands with I-26, I-77, and I-20 bordering or running through the county. The Columbia Metropolitan Airport is located in Lexington County, just 10 miles from the town of Lexington, and is the Southeastern hub for the United Parcel Service. The principal components of the economy of Lexington County are the wholesale and retail trade sector, the manufacturing sector, the government sector, the services sector and the financial, insurance and real estate sector.

The United States Census Bureau estimates that in 2010, Charleston County had a population of 350,209 and the Metro Area had a population of 664,607. Charleston is located on the central and southern east coast surrounded by Berkley and Dorchester counties. Major employers in the area include the United States Navy, the Medical University of South Carolina, Boeing and the Charleston Air Force Base.

Our Business Strategy

First Reliance Bank, founded in 1999, is ranked in the top 25 banks in South Carolina based on total deposits. We have assets of approximately \$495 million, and employ over 100 associates. We serve the Pee Dee, Midlands, and Low Country regions of South Carolina and specialize in providing South Carolina business and consumer customers with a broad array of banking programs, products and services. The Bank is well known in its markets for exceptional customer service and incredible customer loyalty. We are also proud to be one of South Carolina's "Best Places to Work" companies.

Strategic Plan

Our strategic plan is developed annually to execute on our business model. At First Reliance Bank we firmly believe that no company can be successful if they are not crystal clear on why they exist, what they want to accomplish and how they are going to achieve success. Our business model guides in the development of our strategic objectives, goals, budgets and projects.

Our Business Model

Creating Sustainable Company Value through Exceptional Customer Loyalty

Our business model defines how we differentiate ourselves to compete in a strongly commoditized banking environment.

Purpose: “To Make the Lives of Our Customers Better”

The purpose of our company is the “why?” It’s the motivation behind everything we do to achieve our vision.

Associate Promise

Our goal is to build a high performing and highly engaged team. This combination drives superior results when enabled by efficient processes and a differentiated customer value promise.

We promise to provide our associates with an incredible work experience through:

- Committed and Caring Leadership
- Opportunities to Do Their Best Work
- Rewards and recognition that make Their Life Better

Associates are the primary element in creating a differentiated customer experience that cannot be easily duplicated by our competitors.

Customer Value Promise

This defines the unique value we offer to our customers. It's why our customers will want to do business with us. We offer an:

- Incredible Experience
- Distinctive Programs
- Unmatched Convenience

This strategy ensures investments are focused to create loyal relationships with our customers who in return drive revenue in the following ways:

- Customers do more business with us
- Customers refer friends and family to us
- Customers stay with us longer
- Customers allow us to earn a fair profit

Vision: "To Be Recognized as the Largest and Most Profitable Bank in South Carolina"

The vision of our company is the "big picture". It's the declaration of our future goals; it's what we want to accomplish.

Market Strategy

We choose to operate in high-growth markets that have a high concentration of our targeted customer segments. Our goal is to obtain a minimum of 10% of the market share in the markets we serve. Currently we operate in Florence, Lexington and Charleston. This geographic diversity allows us to mitigate credit risk. Our current deposit market share is Florence 14.90%, Lexington 2.64%, and Charleston 0.71%.

Customer Strategy

Our primary customer targets are those individuals who see themselves as a part of Middle America, young adults or small business owners with revenues of \$5 million or less. These are the customers that our brand and value promise resonate with the strongest. In order to differentiate ourselves in the market place, it is impossible to be all things to all people so we are committed to building our programs to serve these special customer segments.

Our goal is to create exceptional customer loyalty!

Customer Relationship Management

We attract and retain customers in two distinct ways through referrals from current customers and providing customers with unique programs and services. Our business customers are provided with a dedicated Relationship Banker who is responsible to manage and provide solutions for the customers' combined business and personal financial needs. We offer our business customers a BetterPerks at work program as a benefit they can offer to employees of their business. Our consumer customers are provided with a selection of distinctive programs that help them meet their personal financial needs and allow them to be part of a unique community.

Currently, we offer distinctive Moms, Gen Y and Home Town Heroes programs. Those customers who choose not to be in a distinctive program are able to be part of our Better Life program. We also offer a community outreach program to offer banking services to the unbanked and under-banked population segments. Our customer relationship strategy is based on leveraging customer information to increase the amount of business customers do with us, refer family, friends and business associates to us, stay with us longer and allow us to earn a fair profit. The key to building loyal customer relationships is to understand their needs and find solutions that make their lives better.

Lending Activities

General. The Bank offers a full range of commercial and consumer loans, as well as commercial real estate loans. Commercial loans are extended primarily to small and middle market customers. Such loans include both secured and unsecured loans for working capital needs (including loans secured by inventory and accounts receivable), business expansion (including acquisition of real estate and improvements), asset acquisition and agricultural purposes. Commercial term loans generally will not exceed a five-year maturity and may be based on a ten or fifteen-year amortization. The extensions of term loans are based upon (1) the ability and stability of the borrower's current management; (2) earnings and trends in cash flow; (3) earnings projections based on reasonable assumptions; (4) the financial strength of the industry and the business itself; and (5) the value and marketability of the collateral. In considering loans for accounts receivable and inventory, the Bank generally uses a declining scale for advances based on an aging of the accounts receivable or the quality and utility of the inventory. With respect to loans for the acquisition of equipment and other assets, the terms depend on the economic life of the respective assets.

Loan Limits and Approval. The Bank's lending activities are subject to a variety of lending limits imposed by federal law. Under South Carolina law, loans by the Bank to a single customer may not exceed 15% of the Bank's unimpaired capital. Based on the Bank's unimpaired capital as of December 31, 2011, the Bank's internal lending limit to a single customer is approximately \$8.2 million, although certain legacy customers exceed this limit in aggregate exposure and the Bank will consider larger requests on a case by case basis. The size of the loans that the Bank is able to offer to potential customers is less than the size of the loans that the Bank's competitors with larger lending limits are able to offer. This limit affects the ability of the Bank to seek relationships with the area's larger businesses. However, the Bank may request other banks to participate in loans to customers when requested loan amounts exceed the Bank's legal lending limit.

Allowance for Loan Losses. We maintain an allowance for loan losses, which has been established through a provision for loan losses charged against income. We charge loans against this allowance when we believe that the collectability of the loan is unlikely. The allowance is an estimated amount that we believe is adequate to absorb losses inherent in the loan portfolio based on evaluations of its collectability. As of December 31, 2011, our allowance for loan losses equaled approximately 2.3% of the average outstanding balance of our loans. Over time, we will base the loan loss reserves on our evaluation of factors including: changes in the nature and volume of the loan portfolio, overall portfolio quality, specific problem loans and commitments, and current anticipated economic conditions that may affect the borrower's ability to pay.

Loan Distribution. As of December 31, 2011, the composition of our loan portfolio by category was approximately as follows :

Industry Categories	Percentage (%)
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Real estate secured	85.00	%
Commercial and industrial	12.02	%
Consumer loans	2.85	%
Other loans	0.13	%
Total	100	%

Real Estate Secured. The Bank has established a mortgage loan division through which it has broadened the range of services that it offers to its customers. The mortgage loan division originates secured real estate loans to purchase existing or to construct new homes and to refinance existing mortgages.

The following are the types of real estate loans originated by the Bank and the general loan-to-value limits set by the Bank with respect to each type.

Raw Land	65%
Land Development	75%
Commercial, multifamily and other nonresidential construction	80%
One to four family residential construction	85%
Improved property	85%
Owner occupied, one to four family and home equity	90% (or less)
Commercial property	80% (or less)

As of December 31, 2011, total loans secured by first or second mortgages on real estate comprised approximately 85% of the Bank's loan portfolio, and the classification of the mortgage loans of the Bank and the respective percentage of the Bank's total loan portfolio of each are as follows (dollars in thousands):

Description	Total Amount as of December 31, 2011	Percentage of Total Loan Portfolio	
Residential 1-4 family	\$ 42,837,510	14.12	%
Multifamily	\$ 8,630,232	2.84	%
Commercial	\$ 133,603,482	44.04	%
Construction	\$ 43,320,482	14.28	%
Second mortgage	\$ 4,503,752	1.48	%
Equity lines of credit	\$ 24,998,277	8.24	%
Total:	\$ 257,893,735	85.00	%

Of the loan types listed above, commercial real estate loans are generally more risky because they are the most difficult to liquidate in light of the current economic downturn that has particularly affected real estate valuations. Construction loans also involve risks due to weather delays and cost overruns.

The Bank generates additional fee income by selling most of its mortgage loans in the secondary market and cross-selling other products and services to its mortgage customers. In 2011, the Bank sold mortgage loans in a total amount of approximately \$34.2 million, or 25.24% of the total number of mortgage loans originated by the Bank. The Bank does not originate or hold subprime residential mortgage loans that were originally intended for sale on the secondary mortgage market.

All Federal Housing Agency ("FHA"), Veterans Administration ("VA") and South Carolina State Housing Finance and Development Authority ("State Housing") loans sold by the Bank involve the right to recourse. The FHA and VA loans are subject to recourse if the loan shows 60 days or more past due in the first four months or goes in to foreclosure within the first 12 months. The State Housing loans are subject to recourse if the loan becomes delinquent prior to purchase by State Housing or if final documentation is not delivered within 90 days of purchase. All investors have a right to require the Bank to repurchase a loan in the event the loan involved fraud. In 2011, of the 232 loans sold by the Bank, 39 were FHA or VA loans and 49 were State Housing Loans, compared to 2010 where, of the 221 loans

sold by the Bank, 53 were FHA or VA loans and 24 were State Housing loans. Such loans represented 36.6% of the dollar volume or 37.9% of the total number of loans sold by the Bank in 2011.

In addition, an increase in interest rates may decrease the demand for consumer and commercial credit, including real estate loans. Gross fees from residential mortgage originations were \$972,173 in 2011.

Commercial and Industrial. As of December 31, 2011, \$36.5 million, or 12% of the Bank's total loan portfolio, was comprised of commercial and industrial loans. Commercial loans involve significant risk because there is generally a small market available for an asset held as collateral that needs to be liquidated. Commercial loans for working capital needs are typically difficult to monitor. We focus our efforts on commercial loans of less than \$3 million. Working capital loans typically have terms not exceeding one year and are usually secured by accounts receivable, inventory, or personal guarantees of the principals of the business. For loans secured by accounts receivable or inventory, principal is typically repaid as the assets securing the loan are converted into cash, and in other cases principal is typically due at maturity.

Consumer. The Bank makes a variety of loans to individuals for personal and household purposes, including secured and unsecured installment loans and revolving lines of credit such as credit cards. Installment loans typically carry balances of less than \$50,000 and are amortized over periods up to 60 months. Consumer loans are offered on a single maturity basis where a specific source of repayment is available. Revolving loan products typically require monthly payments of interest and a portion of the principal.

As of December 31, 2011, the classification of the consumer loans of the Bank and the respective percentage of the Bank's total loan portfolio of each were as follows (dollars in thousands):

Description	Total Outstanding as of December 31, 2011	Percentage of Total Loan Portfolio	
Individuals (household, personal, single pay, installment and other)	\$ 8,187,886	2.70	%
Individuals (household, family, personal credit cards and overdraft protection)	\$ 461,763	0.15	%
All other consumer loans	\$ —	—%	

The risks associated with consumer lending are largely related to economic conditions and increase during economic downturns. Other major risk factors relating to consumer loans include high debt to income ratios and poor loan-to-value ratios. All of the consumer loans set forth above requires a debt service income ratio of no greater than 36% based on gross income.

Deposit Services

The Bank offers a full range of deposit services that are typically available in most banks and savings and loan associations, including checking accounts, NOW accounts, savings accounts and other time deposits of various types, ranging from money market accounts to longer-term certificates of deposit. The transaction accounts and time

certificates are tailored to the Bank's principal market area at rates competitive to those offered by other banks in the area. In addition, the Bank offers certain retirement account services, such as Individual Retirement Accounts ("IRAs"). The Bank solicits deposit accounts from individuals, businesses, associations and organizations and, governmental authorities. All deposit accounts are insured by the Federal Deposit Insurance Corporation ("FDIC") up to the maximum amount allowed by law. For additional information relating to deposit insurance, please see "Supervision and Regulation."

Other Banking Services

The Bank focuses heavily on personal customer service and offers a full range of financial services. Personal products include checking and savings accounts, money market accounts, CDs and IRAs, personal loans and residential mortgage loans, while business products include free checking and savings accounts, commercial lending services, money market accounts, cash management services including remote deposit capture and business deposit courier service. The Bank also offers Internet banking and e-statements, electronic bill paying services, Worldwide ATM networks, free coin machines at all branches, and an overdraft privilege to its customers.

Investments

In addition to its loan operations, the Bank makes other investments primarily in obligations of the United States or obligations guaranteed as to principal and interest by the United States and other taxable and nontaxable securities. The Bank also invests in certificates of deposits in other financial institutions. The amount invested in such time deposits, as viewed on an institution by institution basis, does not exceed \$250,000. Therefore, the amounts invested in certificates of deposit are fully insured by the FDIC. No investment held by the Bank exceeds any applicable limitation imposed by law or regulation. The Bank's finance committee reviews the investment portfolio on an ongoing basis to ascertain investment profitability and to verify compliance with investment policies.

Other Services

In addition to its banking and investment services, the Bank offers securities brokerage services and life insurance products to its customers through a networking arrangement with an independent registered broker-dealer firm.

Competition

The Bank faces strong competition for deposits, loans, and other financial services from numerous other banks, thrifts, credit unions, other financial institutions, and other entities that provide financial services, some of which are not subject to the same degree of regulation as the Bank. Because South Carolina law permits statewide branching by banks and savings and loan associations, many financial institutions in the state have extensive branch networks. In addition, federal law permits interstate banking. Reflecting this opportunity provided by law plus the growth prospects of the Charleston, Florence, and Lexington markets, all of the five largest (in terms of local deposits) commercial banks in our market are branches of or affiliated with regional or super-regional banks.

According to the FDIC, as of June 30, 2011, 35 banks and savings institutions operated 264 offices within Charleston, Florence, and Lexington Counties. All of these institutions aggressively compete for business in the Bank's market area. Some of these competitors have been in business for many years, have established customer bases, are larger than the Bank, have substantially higher lending limits than the Bank has and are able to offer certain services, including trust and international banking services, that the Bank is able to offer only through correspondents, if at all.

The Bank currently conducts business principally through its six branches in Charleston, Florence, and Lexington Counties, South Carolina. Based upon data available on the FDIC's website as of June 30, 2011, the Bank's total deposits ranked eighth among financial institutions in our market area, representing approximately 3.39% of the total deposits in our market area. The table below shows our deposit market share in the counties we serve according to data from the FDIC website as of June 30, 2011.

Market	Number of Branches	Our Market Deposits (in millions)	Total Market Deposits	Ranking	Market Share Percentage	
South Carolina (by county):						
Charleston County	2	\$ 54	\$7,661	18	0.71	%
Florence County	2	296	1,990	2	14.90	
Lexington County	2	83	3,136	10	2.64	

First Reliance Bank (statewide)	6	\$ 433	\$67,872	24	0.64	%
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The Bank competes based on providing its customers with high-quality, prompt, and knowledgeable personalized service at competitive rates, which is a combination that the Bank believes customers generally find lacking at larger institutions. The Bank offers a wide variety of financial products and services at fees that it believes are competitive with other financial institutions.

Employees

On December 31, 2011, the Bank had 95 full-time employees and 19 part-time employees. The executive officers of the Company also serve as executive officers of and are compensated by the Bank. The Company has no employees.

Legal Proceedings

Neither the Company nor any of its properties are subject to any material legal proceedings.

SUPERVISION AND REGULATION

We are subject to extensive state and federal banking regulations that impose restrictions on and provide for general regulatory oversight of our operations. These laws generally are intended to protect depositors and not shareholders. Legislation and regulations authorized by legislation influence, among other things:

- how, when, and where we may expand geographically;
- into what product or service market we may enter;
- how we must manage our assets; and

Under what circumstances money may or must flow between the parent bank holding company and the subsidiary bank.

Set forth below is an explanation of the major pieces of legislation and regulation affecting our industry and how that legislation and regulation affects our actions. The following summary is qualified by reference to the statutory and regulatory provisions discussed. Changes in applicable laws or regulations may have a material effect on our business and prospects, and legislative changes and the policies of various regulatory authorities may significantly affect our operations. We cannot predict the effect that fiscal or monetary policies, or new federal or state legislation may have on our business and earnings in the future.

The Company

Because the Company owns all of the capital stock of First Reliance Bank, we are a bank holding company under the federal Bank Holding Company Act of 1956 (the “Bank Holding Company Act”). As a result, we are primarily subject to the supervision, examination, and reporting requirements of the Bank Holding Company Act and the regulations of the Board of Governors of the Federal Reserve System (the “Federal Reserve”). As a bank holding company located in South Carolina, the South Carolina State Board of Financial Institutions (the “SC State Board”) also regulates and monitors all significant aspects of our operations.

Acquisitions of Banks. The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve before:

- acquiring direct or indirect ownership or control of any voting shares of any bank if, after the acquisition, the bank holding company will directly or indirectly own or control more than 5% of the bank’s voting shares;
- acquiring all or substantially all of the assets of any bank; or
- merging or consolidating with any other bank holding company.

Additionally, the Bank Holding Company Act provides that the Federal Reserve may not approve any of these transactions if it would result in or tend to create a monopoly or substantially lessen competition or otherwise function as a restraint of trade, unless the anti-competitive effects of the proposed transaction are clearly outweighed by the public interest in meeting the convenience and needs of the community to be served. The Federal Reserve is also required to consider the financial and managerial resources and future prospects of the bank holding companies and banks concerned and the convenience and needs of the community to be served. The Federal Reserve's consideration of financial resources generally focuses on capital adequacy, which is discussed below.

Under the Bank Holding Company Act, if adequately capitalized and adequately managed, the Company or any other bank holding company located in South Carolina may purchase a bank located outside of South Carolina. Conversely, an adequately capitalized and adequately managed bank holding company located outside of South Carolina may purchase a bank located inside South Carolina. In each case, however, restrictions may be placed on the acquisition of a bank that has only been in existence for a limited amount of time or will result in specified concentrations of deposits. For example, South Carolina law prohibits a bank holding company from acquiring control of a financial institution until the target financial institution has been incorporated for five years.

Change in Bank Control. Subject to various exceptions, the Bank Holding Company Act and the Change in Bank Control Act, together with related regulations, require Federal Reserve approval prior to any person or company acquiring "control" of a bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of the bank holding company. Control is rebuttably presumed to exist if a person or company acquires 10% or more, but less than 25%, of any class of voting securities and either:

- the bank holding company has registered securities under Section 12 of the Securities Act of 1934; or
- no other person owns a greater percentage of that class of voting securities immediately after the transaction.

Our common stock is registered under Section 12 of the Securities Exchange Act of 1934. The regulations provide a procedure for challenging rebuttable presumptions of control.

Permitted Activities. The Bank Holding Company Act has generally prohibited a bank holding company from engaging in activities other than banking or managing or controlling banks or other permissible subsidiaries and from acquiring or retaining direct or indirect control of any company engaged in any activities other than those determined by the Federal Reserve to be closely related to banking or managing or controlling banks as to be a proper incident thereto. Provisions of the Gramm-Leach-Bliley Act have expanded the permissible activities of a bank holding company that qualifies as a financial holding company. Under the regulations implementing the Gramm-Leach-Bliley Act, a financial holding company may engage in additional activities that are financial in nature or incidental or complementary to financial activities. Those activities include, among other activities, certain insurance and securities activities.

To qualify to become a financial holding company, the Bank and any other depository institution subsidiary of the Company must be well capitalized and well managed and must have a Community Reinvestment Act rating of at least “satisfactory.” Additionally, the Company must file an election with the Federal Reserve to become a financial holding company and must provide the Federal Reserve with 30 days’ written notice prior to engaging in a permitted financial activity. While the Company meets the qualification standards applicable to financial holding companies, the Company has not elected to become a financial holding company at this time.

Support of Subsidiary Institutions. Under Federal Reserve policy, we are expected to act as a source of financial strength for the Bank and to commit resources to support the Bank. In addition, pursuant to the Dodd-Frank Wall Street and Consumer Protection Act (the “Dodd-Frank Act”), the federal banking regulators are required to issue, within two years of enactment, rules that require a bank holding company to serve as a source of financial strength for any depository institution subsidiary. This support may be required at times when, without this Federal Reserve policy or the impending rules, we might not be inclined to provide it. In addition, any capital loans made by us to the Bank will be repaid only after the Bank’s deposits and various other obligations are repaid in full. In the unlikely event of our bankruptcy, any commitment that we give to a bank regulatory agency to maintain the capital of the Bank will be assumed by the bankruptcy trustee and entitled to a priority of payment.

South Carolina Law. As a bank holding company with its principal offices in South Carolina, the Company is subject to limitations on sale or merger and to regulation by the SC State Board. The Company must receive the approval of the SC State Board prior to acquiring control of a bank or bank holding company or all or substantially all of the assets of a bank or a bank holding company. The Company also must file with the SC State Board periodic reports with respect to its financial condition, operations and management, and the intercompany relationships between the Company and its subsidiaries.

TARP Participation. On October 14, 2008, the U.S. Treasury announced the capital purchase component of TARP. This program was instituted by the U.S. Treasury pursuant to the Emergency Economic Stabilization Act of 2008, which provided up to \$700 billion to the U.S. Treasury to, among other things, take equity ownership positions in financial institutions. The TARP capital purchase program was intended to encourage financial institutions to build capital and thereby increase the flow of financing to businesses and consumers. We participated in the capital purchase component of TARP.

Use of TARP Proceeds. On March 6, 2009, the Company received an investment of \$15.3 million under the TARP Capital Purchase Program ("TARP CPP"). The TARP CPP funds were initially placed in the Company's demand deposit account with the Bank, providing liquidity to the Bank while preserving the Company's flexibility in how to best support the Bank, including the Bank's lending efforts. To date, the Company has contributed \$8.8 million to the Bank as capital; as a result of this capital infusion, as well as a successful private offering of our Series C Preferred Stock in May 2010, the Bank's Tier 1 leverage ratio was 8.96%, and its total risk-based capital ratio was 13.59%, both as of year-end 2011.

Due to the Bank's capital policy, which requires the Bank to maintain no less than 10% capital, the TARP CPP proceeds enabled the Bank to increase its lending capacity by approximately \$78 million. The Company is ready to contribute additional funds as capital to the Bank to support further increases in lending when and if loan demand increases. We believe the TARP CPP funds have strengthened the Bank's capacity to respond to the legitimate credit needs of our customers and communities. We have advised our customers, employees, and other stakeholders of our commitment to support our communities' growth and of our receipt of TARP CPP funds, which strengthens our ability to make loans. Since protecting our capital ratios with the TARP CPP injection, we have not found it necessary to send good customers away. Although our market area has suffered through a historic recession and loan demand is lower than in recent years, we remain committed to supporting the future growth of our markets. The TARP CPP proceeds not only provided us with additional lending capacity, but also permitted us to strengthen our balance sheet. That strength allows us the flexibility to offer innovative programs, such as our *Hometown Heroes* checking account with embedded loan program offers. In 2009, we received statewide recognition when the South Carolina Finance and Housing Authority honored us as Lender of the Year.

The Bank

Because the Bank is a commercial bank chartered under the laws of the State of South Carolina, it is primarily subject to the supervision, examination, and reporting requirements of the FDIC and the SC State Board. The FDIC and the SC State Board regularly examine the Bank's operations and have the authority to approve or disapprove mergers, the establishment of branches, and similar corporate actions. Both regulatory agencies have the power to prevent the continuance or development of unsafe or unsound banking practices or other violations of law. Additionally, the Bank's deposits are insured by the FDIC to the maximum extent provided by law. The Bank is also subject to numerous state and federal statutes and regulations that affect our business, activities, and operations.

South Carolina Law. Commercial banks chartered in South Carolina have only those powers granted by law or by the regulations of the SC State Board. State law sets specific requirements for bank capital and regulates deposits in and loans and investments by banks, including the amounts, types, and, in some cases, rates. In addition, the SC State Board regulates, among other activities, the payment of dividends, the opening of branches, loans to officers and directors, record keeping, and the use of automated teller machines. The SC State Board periodically examines state banks to determine their compliance with the law and regulations, and state banks must make periodic reports of their condition to the SC State Board. Prior to the enactment of the Dodd-Frank Act, the Bank and any other national or state-chartered bank were generally permitted to branch across state lines by merging with banks in other states if allowed by the applicable states' laws. As a result of the Dodd-Frank Act, however, interstate branching is now permitted for all national- and state-chartered banks, provided that a state bank chartered by the state in which the branch is to be located would also be permitted to establish a branch.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991 establishes a system of prompt corrective action to resolve the problems of undercapitalized financial institutions. Under this system, the federal banking regulators have established five capital categories in which all institutions are placed: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The federal

banking agencies have also specified by regulation the capital levels required for each category.

As a bank's capital position deteriorates, federal banking regulators are required to take various mandatory supervisory actions and are authorized to take other discretionary actions with respect to institutions in the three undercapitalized categories. The severity of the action depends upon the capital category in which the institution is placed. Generally, subject to a narrow exception, the banking regulator must appoint a receiver or conservator for an institution that is critically undercapitalized. As of December 31, 2011, the Bank was considered "well capitalized" for regulatory purposes.

A "well-capitalized" bank is one that is not required to meet and maintain a specific capital level for any capital measure, pursuant to any written agreement, order, capital directive, or prompt corrective action directive, and has a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital ratio of at least 6%, and a Tier 1 leverage ratio of at least 5%. Generally, a classification as well capitalized will place a bank outside of the regulatory zone for purposes of prompt corrective action. However, a well-capitalized bank may be reclassified as "adequately capitalized" based on criteria other than capital if the federal regulator determines that a bank is in an unsafe or unsound condition, or is engaged in unsafe or unsound practices, which requires certain remedial action.

An “adequately-capitalized” bank meets the required minimum level for each relevant capital measure, including a total risk-based capital ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 4%, and a Tier 1 leverage ratio of at least 4%. A bank that is adequately capitalized is prohibited from directly or indirectly accepting, renewing, or rolling over any brokered deposits without applying for and receiving a waiver from the applicable regulatory authorities. Institutions that are not well capitalized are also prohibited, except in very limited circumstances where the FDIC permits use of a higher local market rate, from paying yields for deposits in excess of 75 basis points above a national average rate for deposits of comparable maturity, as calculated by the FDIC. In addition, all institutions are generally prohibited from making capital distributions and paying management fees to controlling persons if, subsequent to such distribution or payment, the institution would be undercapitalized. Finally, an adequately-capital