

FIRST RELIANCE BANCSHARES INC
Form 10-K
March 17, 2014

**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, 2013

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

(State of Incorporation)

80-0030931

(I.R.S. Employer Identification No.)

2170 W. Palmetto Street, Florence, South Carolina

(Address of Principal Executive Offices)

29501

(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

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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

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, 2013 was approximately \$8.2 million, based on the registrant's closing sales price of \$1.80 as reported on the Over-the Counter Bulletin Board on June 30, 2013. There were 4,569,895 shares of the registrant's common stock outstanding as of March 10, 2014.

DOCUMENTS INCORPORATED BY REFERENCE

Document	Parts Into Which Incorporated
Annual Report to Shareholders for the Year Ended December 31, 2013	Part II
Proxy Statement for the Annual Meeting of Shareholders to be held June 5, 2014	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;
- the impacts of renewed regulatory scrutiny on consumer protection and compliance led by the newly-created Consumer Finance Protection Bureau;
- 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, including the undetermined effects of the Federal Reserve’s “Quantitative Easing” program, as well as other legislative and regulatory changes;
- changes in capital standards and asset risk-weighting included in proposed Federal Reserve rules to implement the so-called “Basel III” accords;

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");

the risks of changes in interest rates or an unprecedented period of record-low 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 25.

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 quoted 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 2012, Florence County had an estimated population of 137,948. 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, Otis Elevator, Johnson Controls, Monster.com, McLeod Regional Medical Center, and Carolinas

Medical Center. Florence County's economy is largely based on 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 2012 of 270,406. 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, 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 2012, Charleston County had a population of 365,162 and the Metro Area had a population of 697,439. 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 is ranked in the top 25 banks in South Carolina based on total deposits. We have assets of approximately \$355 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. We believe 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 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 seek 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 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 13.19%, Lexington 2.26%, and Charleston 0.64%.

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.

Customer Relationship Management

To attract low- cost core deposits we offer our customers 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 a distinctive "Moms", Gen "Y" and "Home Town Heroes" Program. Those customers who choose not to be in a distinctive program are able to be part of our "Better Life" program. Our customer relationship strategy is based on building loyal relationships with customers. In return our customers do more business with us, refer family, friends and business associates to us, stay with us long and allow us to earn a fair profit. The key to building loyal customer relationships is to understand their needs, motivation and find solutions that make their lives better.

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 "Better Perks" at work program as a benefit they can offer to employees of their business.

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, 2013, the Bank's internal lending limit to a single customer is approximately \$6.1 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, 2013, our allowance for loan losses equaled approximately 1.2% 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, 2013, the composition of our loan portfolio by category was approximately as follows:

Industry Categories	Percentage (%)	
Real estate secured	81.45	%
Commercial and industrial	13.62	%
Consumer loans	4.92	%
Other loans	0.01	%
Total	100.00	%

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.

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- 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, 2013, total loans secured by first or second mortgages on real estate comprised approximately 81.45% 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:

Description	Total Amount as of December 31, 2013	Percentage of Total Loan Portfolio	
Residential 1-4 family	\$ 35,873,036	15.04	%
Multifamily	\$ 4,312,057	1.81	%
Commercial	\$ 104,378,485	43.76	%
Construction	\$ 24,175,347	10.14	%
Second mortgage	\$ 4,245,778	1.78	%
Equity lines of credit	\$ 21,270,126	8.92	%
Total:	\$ 194,254,829	81.46	%

Of the loan types listed above, commercial real estate loans are generally more risky because they are the most difficult to liquidate in the current real estate market that has made real estate valuation particularly volatile. Construction loans are often speculative in nature and can involve additional risk due to weather delays and cost overruns.

The Bank generates additional fee income by selling some of its mortgage loans in the secondary market and cross-selling other products and services to its mortgage customers. In 2013, the Bank sold mortgage loans in a total amount of approximately \$29.1 million, or 28.0% 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 2013, of the 168 loans sold by the Bank, 43 were FHA or VA loans and 10 were State Housing Loans, compared to 2012 where, of the 247 loans sold by the Bank, 57 were FHA or VA loans and 25 were State Housing loans. Such loans represented 27.1% of the dollar volume or 39.9% of the total number of loans sold by the Bank in 2013.

In addition, an increase in interest rates may decrease the demand for consumer and commercial credit, including real estate loans. Gross gains from sales of residential mortgage loans were \$1,029,641 in 2013.

Commercial and Industrial. As of December 31, 2013, \$32.5 million, or 13.62% of the Bank's total loan portfolio, was comprised of commercial and industrial loans. We focus our efforts on commercial loans of less than \$3 million. Commercial loans involve significant risk because there is generally a small market available for assets held as collateral that needs to be liquidated. Commercial loans for working capital needs are typically difficult to monitor. Working capital loans typically have terms not exceeding one year and are usually secured by accounts receivable, inventory, personal guarantees of the principals or fixed assets 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, 2013, 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, 2013	Percentage of Total Loan Portfolio	
Individuals (household, personal, single pay, installment and other)	\$ 11,292,865	4.69	%
Individuals (household, family, personal credit cards and overdraft protection)	\$ 432,454	0.18	%
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. Consumer lending standards 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 for customers, 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, 2013, 36 banks and savings institutions operated 251 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.

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, 2013, the Bank had 86 full-time employees and 24 part-time employees. The executive officers of the Company also serve as executive officers of and are compensated by the Bank. Other than our executive officers, the Company has no employees.

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:

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- 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 Reform and Consumer Protection Act (the “Dodd-Frank Act”), this longstanding policy has been given the force of law and additional regulations promulgated by the Federal Reserve to further implement the intent of the new statute are possible. As in the past, such financial support from the Company may be required at times when, without this legal requirement, 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.

On March 1, 2013, the United States Department of the Treasury (the “Treasury”), the holder of all 15,249 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the “Series A Shares”), and 767 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series B (the “Series B Shares”), announced that it had

auctioned the securities in a private transaction with unaffiliated third-party investors. The Company received no proceeds from the transaction. The clearing prices for the Series A Shares and the Series B Shares were \$679.61 per share and \$822.61, respectively. Both series have a liquidation preference of \$1,000 per share. The closing of the private sale occurred on March 11, 2013.

The sale of the securities had no effect on their terms, including the Company's obligation to satisfy accrued and unpaid dividends (aggregating approximately \$1.9 million) prior to payment of any dividend or other distribution to holders of *pari passu* or junior stock, including the Company's common stock, and an increase in the dividend rate on the Series A Shares from 5% to 9% on May 15, 2014. Further, the sale of the securities will have no effect on the Company's capital, financial condition or results of operations. However, the Company generally will not be subject to various executive compensation and corporate governance requirements to which it was subject while Treasury held the securities.

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 10.67%, and its total risk-based capital ratio was 14.35%, both as of year-end 2013.

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.

Payment of Dividends. We are a legal entity separate and distinct from the Bank. The principal source of our cash flow, including cash flow to pay dividends to stockholders, is dividends that we receive from the Bank. As will be noted more fully below, statutory and regulatory limitations apply to the payment of dividends by a subsidiary bank to its bank holding company.

The payment of dividends by us and the Bank may also be affected by other factors, including other restrictions imposed under discretionary powers afforded our state and federal regulators. For example, if, in the opinion of the FDIC, the Bank was engaged in or about to engage in an unsafe or unsound practice, the FDIC could require, after notice and a hearing, that the Bank stop or refrain from engaging in the practice. The federal banking agencies have indicated that paying dividends that deplete a depository institution's capital base to an inadequate level would be an unsafe and unsound banking practice. Under the FDIC Improvement Act of 1991 (the "FDIA"), a depository institution may not pay any dividend if payment would cause it to become undercapitalized or if it already is undercapitalized. Moreover, the federal agencies have issued policy statements that provide that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

When we received a capital investment from the Treasury under the TARP CPP, we became subject to additional limitations on the payment of dividends. These limitations require, among other things, that all dividends for the securities purchased under the TARP CPP be paid before other dividends can be paid.

Furthermore, the Federal Reserve Board clarified its guidance on dividend policies for bank holding companies through the publication of a Supervisory Letter, dated February 24, 2009. As part of the letter, the Federal Reserve

Board encouraged bank holding companies, particularly those that had participated in the TARP CPP, to consult with the Federal Reserve Board prior to dividend declarations and redemption and repurchase decisions even when not explicitly required to do so by federal regulations. The Federal Reserve Board has indicated that TARP CPP recipients, such as the Company, should consider and communicate in advance to regulatory staff how proposed dividends, capital repurchases, and capital redemptions are consistent with its obligation to eventually redeem the securities held by the Treasury. This new guidance is largely consistent with prior regulatory statements encouraging bank holding companies to pay dividends out of net income and to avoid dividends that could adversely affect the capital needs or minimum regulatory capital ratios of the bank holding company and its subsidiary bank.

Any future determination relating to our dividend policy will be made at the discretion of the Board of Directors and will depend on many of the statutory and regulatory factors mentioned above.

Memoranda of Understanding. Following an examination of the Bank by the FDIC during the first quarter of 2010, the Bank's Board of Directors agreed to enter into a Memorandum of Understanding (the "Bank MOU") with the FDIC and SC State Board, that became effective August 19, 2010. Among other things, the Bank MOU provides for the Bank to (i) review and formulate objectives relative to liquidity and growth, including a reduction in reliance on volatile liabilities, (ii) formulate plans for the reduction and improvement in adversely classified assets, (iii) maintain a Tier 1 leverage capital ratio of 8% and continue to be "well capitalized" for regulatory purposes, (iv) continue to maintain an adequate allowance for loan and lease losses, (v) not pay any dividend to the Bank's parent holding company without the approval of the regulators, (vi) review officer performance and consider additional staffing needs, and (vii) provide progress reports and submit various other information to the regulators.

In addition, on the basis of the same examination by the FDIC and the SC State Board, the Federal Reserve Bank of Richmond (the "Federal Reserve Bank") requested that the Company enter into a separate Memorandum of Understanding (the "Company MOU"). The Company entered into the Company MOU in December 2010. While the Company MOU provides for many of the same measures as the Bank MOU, the regulatory commitments suggested by the Federal Reserve Bank require that the Company seek pre-approval prior to the payment of dividends or other interest payments relating to its securities.

As a result, until the Company is no longer subject to the Company MOU, it will be required to seek regulatory approval prior to paying scheduled dividends on its preferred stock and trust preferred securities, including the Series A Preferred Stock and Series B Preferred Stock issued to the Treasury as part of our participation in the TARP CPP, as well as the Series C Preferred Stock issued as part of a private offering earlier this year. This provision will also apply to the Company's common stock, although, to date, the Company has not elected to pay a cash dividend on its shares of common stock. The Federal Reserve Bank approved the scheduled payment of dividends on the Company's preferred stock and interest payments on the Company's trust preferred securities for the first three quarters of 2011. The Federal Reserve Bank has not approved the payment of dividends on the Company's preferred stock or interest relating to its outstanding classes of trust preferred securities since the third quarter of 2011. Since the Company has not paid scheduled dividends on its outstanding shares of Series A and Series B Preferred Stock for in excess of six fiscal quarters, the holders of those shares are entitled to name two individuals to our board of directors but have not yet elected to do so. No assurance can be given as to when the Company will obtain approval from the Federal Reserve Bank to resume the payment of such dividends and interest in future quarters while the Company MOU remains in effect.

In response to these regulatory matters, the Bank and the Company have taken various actions designed to address the issues raised in the MOUs and otherwise improve lending procedures and other conditions related to our operations. Among other actions, the Bank, in collaboration with the Company, formed a Loss Mitigation and Recovery Division staffed with experienced bankers who specifically handle non-performing and deteriorating assets, which are largely localized to coastal South Carolina. The Bank has also moved, under the supervision of its Special Risk Committee, to strengthen the Bank's existing credit review process, aggressive risk review methodology, and conservative lending policies as part of a company-wide risk management assessment.

Sarbanes-Oxley Act of 2002. On July 30, 2002, the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") was signed into law and became some of the most sweeping federal legislation addressing accounting, corporate governance, and disclosure issues. The impact of the Sarbanes-Oxley Act is wide-ranging as it applies to all public companies and imposes significant new requirements for public company governance and disclosure requirements.

In general, the Sarbanes-Oxley Act mandated important new corporate governance and financial reporting requirements intended to enhance the accuracy and transparency of public companies' reported financial results. It

established new responsibilities for corporate chief executive officers, chief financial officers and audit committees in the financial reporting process and creates a new regulatory body to oversee auditors of public companies. It backed these requirements with new SEC enforcement tools, increases criminal penalties for federal mail, wire and securities fraud, and created new criminal penalties for document and record destruction in connection with federal investigations. It also increased the opportunity for more private litigation by lengthening the statute of limitations for securities fraud claims and provided new federal corporate whistleblower protection.

The economic and operational effects of this legislation on public companies, including us, is significant in terms of the time, resources and costs associated with complying with this law. Because the Sarbanes-Oxley Act, for the most part, applies equally to larger and smaller public companies, we are presented with additional challenges as a smaller, community-oriented financial institution seeking to compete with larger financial institutions in our market.

In 2010, the Dodd-Frank Act was signed into law and included a permanent delay of the implementation of section 404(b) of the Sarbanes-Oxley Act for companies with non-affiliated public float under \$75.0 million (“non-accelerated filer”). Section 404(b) is the requirement to have an independent accounting firm audit and attest to the effectiveness of a Company’s internal controls. As the Company currently qualifies as a non-accelerated filer under the SEC rules and expects to remain one through fiscal year 2014, there are no additional costs anticipated for complying with Section 404(b).

Regulation of the Bank

The Bank is an insured, South Carolina-chartered bank. The Bank’s deposits are insured as part of the FDIC’s Deposit Insurance Fund (“DIF”), and it is subject to supervision and examination by, and the regulations and reporting requirements of, the FDIC and the SC State Board. The FDIC and the SC State Board are the Bank’s primary federal and state banking regulators. The Bank is not a member bank of the Federal Reserve.

The FDIC and the SC State Board regulate all areas of the Bank’s business, including its reserves, mergers, payment of dividends and other aspects of its operations. They regularly examine the bank, and the Bank must furnish periodic reports to the FDIC and the SC State Board containing detailed financial and other information about its affairs. The FDIC and the SC State Board have broad powers to enforce laws and regulations that apply to the Bank and to require it to correct conditions that affect its safety and soundness. Among others, these powers include issuing cease and desist orders, imposing civil penalties, and removing officers and directors, and their ability otherwise to intervene in the Bank’s operation if their examinations of the bank, or the reports it files, reflect a need for them to do so.

As an insured bank, the Bank is prohibited from engaging as principal in any activity that is not permitted for national banks unless (1) the FDIC determines that the activity or investment would not pose a significant risk to the DIF, and (2) the Bank is, and continue to be, in compliance with the capital standards that apply to it. The Bank also is prohibited from directly acquiring or retaining any equity investment of a type or in an amount that is not permitted for national banks.

Prior to the enactment of the Dodd-Frank Act (which is discussed more fully below), 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.

The Bank’s business also is influenced by prevailing economic conditions and governmental policies, both foreign and domestic, and by the monetary and fiscal policies of the Federal Reserve. The Bank is not a member of the Federal Reserve. However, under the Federal Reserve’s regulations, all FDIC-insured banks must maintain average daily reserves against their transaction accounts. Currently, no reserves are required on the first \$13.3 million of transaction accounts, but a bank must maintain reserves equal to 3.0% on aggregate balances between \$13.3 million and \$89.0 million, and reserves equal to 10.0% on aggregate balances in excess of \$89.0 million. The Federal Reserve may adjust these percentages from time to time. Because the Bank’s reserves must be maintained in the form of vault cash or in an account at a Federal Reserve Bank or with a qualified correspondent bank, one effect of the reserve requirement is to reduce the amount of the bank’s assets that are available for lending and other investment activities. The Federal Reserve’s actions and policy directives determine to a significant degree the cost and availability of funds the Bank obtains from money market sources for lending and investing, and they also influence, directly and

indirectly, the rates of interest the bank pays on time and savings deposits and the rates it charges on commercial bank loans.

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Dodd-Frank Act. During 2010, the bank regulatory landscape was dramatically changed by the Dodd-Frank Act which was enacted on July 21, 2010 and which implements far-reaching regulatory reform. Among its many significant provisions, the Dodd-Frank Act:

- established the Financial Stability Oversight Counsel made up of the heads of the various bank regulatory and other agencies to identify and respond to risks to U.S. financial stability arising from ongoing activities of large financial companies;

- established centralized responsibility for consumer financial protection by creating a new Consumer Financial Protection Bureau which will be responsible for implementing, examining and enforcing compliance with federal consumer financial laws with respect to financial institutions with over \$10 billion in assets;

- required that banking agencies establish for most bank holding companies the same leverage and risk-based capital requirements as apply to insured depository institutions, and that bank holding companies and banks be well-capitalized and well managed in order to acquire banks located outside their home states;

- prohibits bank holding companies from including new trust preferred securities in their Tier 1 capital and, beginning with a three-year phase-in period on January 1, 2013, requires bank holding companies with assets over \$15 billion to deduct existing trust preferred securities from their Tier 1 capital;

- required the FDIC to set a minimum DIF reserve ratio of 1.35% and that the DIF reserve ratio be increased to that level by September 30, 2020; that FDIC off-set the effect of the higher minimum ratio on insured depository institutions with assets of less than \$10 billion; and that FDIC change the assessment base used for calculating insurance assessments from the amount of insured deposits to average consolidated total assets minus average tangible equity;

- established a permanent \$250,000 limit for federal deposit insurance and repealed the federal prohibition on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts;

- amended the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that those fees be reasonable and proportional to the actual cost of a transaction to the issuer; and

- required implementation of various corporate governance processes affecting areas such as executive compensation and proxy access by shareholders.

Many provisions of the Dodd-Frank Act are subject to rulemaking by bank regulatory agencies and the SEC and will take effect over time, making it difficult to anticipate the overall financial impact on financial institutions and consumers. However, many provisions in the Dodd-Frank Act (including those permitting the payment of interest on demand deposits and restricting interchange fees) are likely to increase expenses and reduce revenues for all financial institutions.

Consumer Financial Protection Bureau (“CFPB”). The Dodd-Frank Act created a new, independent federal agency, the CFPB, which was granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the laws referenced above, fair lending laws and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets, their service providers and certain non-depository entities such as debt collectors and consumer

reporting agencies. Although the Bank has less than \$10 billion in assets, the impact of the formation of the CFPB has caused a ripple effect across all bank regulatory agencies, and placed a renewed focus on consumer protection and compliance efforts.

For examples of this new authority, the CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, the Dodd-Frank Act allows borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage" as defined by the CFPB. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

The CFPB has concentrated much of its rulemaking efforts on a variety of mortgage-related topics required under the Dodd-Frank Act, including mortgage origination disclosures, minimum underwriting standards and ability to repay, high-cost mortgage lending, and servicing practices. During 2012, the CFPB issued three proposed rulemakings covering loan origination and servicing requirements, which were finalized in January 2013, along with other rules on mortgages. The escrow and loan originator compensation rules are scheduled to become effective in June 2013. The ability to repay and qualified mortgage standards rules, as well as the mortgage servicing rules, became effective in January 2014. A final rule integrating disclosures required by the Truth in Lending Act and the Real Estate Settlement and Procedures Act also became effective in January 2014. We continue to analyze the impact that such rules may have on our business model, particularly with respect to our mortgage banking division.

Restrictions on Payment of Dividends. Under South Carolina law, the Bank is authorized to upstream to the Company, by way of a cash dividend, up to 100% of the Bank's net income in any calendar year without obtaining the prior approval of the SC State Board, provided that the Bank received a CAMELS composite rating of one or two at the last examination conducted by a state or federal regulatory authority. All other cash dividends require prior approval by the SC State Board. South Carolina law requires each state nonmember bank to maintain the same reserves against deposits as are required for a state member bank under the Federal Reserve Act. This requirement is not expected to limit the ability of the Bank to pay dividends on its common stock.

The payment of dividends by the Bank may also be affected by other factors, such as the requirement to maintain adequate capital above regulatory guidelines. If, in the opinion of the FDIC, the Bank was engaged in or about to engage in an unsafe or unsound practice, the FDIC could require, after notice and a hearing, that the Bank stop or refrain from engaging in the practice. The federal banking agencies have indicated that paying dividends that deplete a depository institution's capital base to an inadequate level would be an unsafe and unsound banking practice. Under the Federal Deposit Insurance Corporation Improvement Act of 1991, a depository institution may not pay any dividend if payment would cause it to become undercapitalized or if it already is undercapitalized. Moreover, the federal agencies have issued policy statements that provide that bank holding companies and insured banks should generally only pay dividends out of current operating earnings. The Bank's payment of dividends also could be affected or limited by other factors, such as events or circumstances which lead the FDIC to require (as further described below) that it maintain capital in excess of regulatory guidelines.

In the future, the Bank's ability to declare and pay cash dividends will be subject to regulatory considerations as well as its board of directors' evaluation of the Bank's operating results, capital levels, financial condition, future growth plans, general business and economic conditions, and tax and other relevant considerations. See "Supervision and Regulation Memoranda of Understanding" above.

Regulatory Guidance on "CRE" Lending Concentrations. During 2006, the FDIC and other federal banking regulators issued guidance for sound risk management for financial institutions whose loan portfolios are deemed to have significant concentrations in commercial real estate ("CRE"). In March 2008, the FDIC and other federal banking regulators issued further guidance on applying these principles in the current real estate lending environment, and they noted particular concern about construction and development loans. The banking regulators have indicated that this guidance does not set strict limitations on the amount or percentage of CRE within any given loan portfolio, and that they also will examine risk indicators in banks which have amounts or percentages of CRE below the thresholds. However, if a bank's CRE exceeds these thresholds or if other risk indicators are present, the FDIC and other federal banking regulators may require additional reporting and analysis to document management's evaluation of the potential additional risks of such concentration and the impact of any mitigating factors. The March 2008 supplementary guidance stated that banks with significant CRE concentrations should maintain or implement processes to:

· increase and maintain strong capital levels;

- ensure that their loan loss allowances are appropriately strong;
- closely manage their CRE and construction and development loan portfolios;
- maintain updated financial and analytical information about borrowers and guarantors; and
- bolster their workout infrastructure for problem loans.

It is possible that regulatory constraints associated with this guidance could adversely affect the Bank's ability to grow CRE assets, and they also could increase the costs of monitoring and managing this component of the bank's loan portfolio.

Capital Adequacy. The Bank is required to comply with the FDIC's capital adequacy standards for insured banks. The FDIC has issued risk-based capital and leverage capital guidelines for measuring capital adequacy, and all applicable capital standards must be satisfied for the Bank to be considered in compliance with regulatory capital requirements.

Under the FDIC's risk-based capital measure, the minimum ratio ("Total Capital Ratio") of the Bank's total capital ("Total Capital") to its risk-weighted assets (including various off-balance-sheet items, such as standby letters of credit) is 8.0%. At least half of Total Capital must be composed of "Tier 1 Capital." Tier 1 Capital includes common equity, undivided profits, minority interests in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and a limited amount of cumulative perpetual preferred stock, less goodwill and various other intangible assets. The remainder of Total Capital may consist of "Tier 2 Capital" which includes certain subordinated debt, certain hybrid capital instruments and other qualifying preferred stock, and a limited amount of loan loss reserves. A bank that does not satisfy minimum capital requirements may be required to adopt and implement a plan acceptable to its federal banking regulator to achieve an adequate level of capital.

Under the leverage capital measure, the minimum ratio ("Leverage Capital Ratio") of Tier 1 Capital to average assets, less goodwill and various other intangible assets, generally is 4.0%. The FDIC's guidelines also provide that banks experiencing internal, growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum levels without significant reliance on intangible assets, and a bank's "Tangible Leverage Ratio" (determined by deducting all intangible assets) and other indicators of a bank's capital strength also are taken into consideration by banking regulators in evaluating proposals for expansion or new activities.

The FDIC also considers interest rate risk (arising when the interest rate sensitivity of the Bank's assets does not match the sensitivity of its liabilities or its off-balance-sheet position) in the evaluation of the bank's capital adequacy. Banks with excessive interest rate risk exposure are required to hold additional amounts of capital against their exposure to losses resulting from that risk. Through the risk-weighting of assets, the regulators also require banks to incorporate market risk components into their risk-based capital. Under these market risk requirements, capital is allocated to support the amount of market risk related to a bank's lending and trading activities.

The Bank's capital categories are determined solely for the purpose of applying the "prompt corrective action" rules described below and they are not necessarily an accurate representation of its overall financial condition or prospects for other purposes. A failure to meet the capital guidelines could subject the Bank to a variety of enforcement actions under those rules, including the issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on the taking of brokered deposits, and other restrictions on its business. As described below, the FDIC also can impose other substantial restrictions on banks that fail to meet applicable capital requirements.

Basel III Capital Standards. In December 2010, the Basel Committee on Banking Supervision, an international forum for cooperation on banking supervisory matters, announced the "Basel III" capital standards, which substantially revised the existing capital requirements for banking organizations. Modest revisions were made in June 2011. The Basel III standards operate in conjunction with portions of standards previously released by the Basel Committee and commonly known as "Basel II" and "Basel 2.5." On June 7, 2012, the Federal Reserve, the Office of the Comptroller of the Currency (the "OCC"), and the FDIC requested comment on these proposed rules that, taken together, would implement the Basel regulatory capital reforms through what we refer to herein as the "Basel III capital framework."

On July 2, 2013, the Federal Reserve adopted a final rule for the Basel III capital framework and, on July 9, 2013, the OCC also adopted a final rule and the FDIC adopted the same provisions in the form of an "interim" final rule. The rule

will apply to all national and state banks (such as the Bank) and savings associations and most bank holding companies and savings and loan holding companies, which we collectively refer to herein as “covered” banking organizations. Bank holding companies with less than \$500 million in total consolidated assets, such as the Company, are not subject to the final rule, nor are savings and loan holding companies substantially engaged in commercial activities or insurance underwriting. The requirements in the rule begin to phase in on January 1, 2015 for covered banking organizations such as the Company. The requirements in the rule will be fully phased in by January 1, 2019.

The rule imposes higher risk-based capital and leverage requirements than those currently in place. Specifically, the rule imposes the following minimum capital requirements:

- a new common equity Tier 1 risk-based capital ratio of 4.5%;
- a Tier 1 risk-based capital ratio of 6% (increased from the current 4% requirement);
- a total risk-based capital ratio of 8% (unchanged from current requirements); and
- a leverage ratio of 4% (currently 3% for depository institutions with the highest supervisory composite rating and 4% for other depository institutions).

Under the rule, Tier 1 capital is redefined to include two components: Common Equity Tier 1 capital and additional Tier 1 capital. The new and highest form of capital, Common Equity Tier 1 capital, consists solely of common stock (plus related surplus), retained earnings, accumulated other comprehensive income, and limited amounts of minority interests that are in the form of common stock. Additional Tier 1 capital includes other perpetual instruments historically included in Tier 1 capital, such as non-cumulative perpetual preferred stock. The rule permits bank holding companies with less than \$15 billion in total consolidated assets to continue to include trust preferred securities and cumulative perpetual preferred stock issued before May 19, 2010 in Tier 1 capital, but not in Common Equity Tier 1 capital, subject to certain restrictions. Tier 2 capital consists of instruments that currently qualify in Tier 2 capital plus instruments that the rule has disqualified from Tier 1 capital treatment.

In addition, in order to avoid restrictions on capital distributions or discretionary bonus payments to executives, a covered banking organization must maintain a “capital conservation buffer” on top of its minimum risk-based capital requirements. This buffer must consist solely of Tier 1 Common Equity, but the buffer applies to all three measurements (Common Equity Tier 1, Tier 1 capital and total capital). The capital conservation buffer will be phased in incrementally over time, becoming fully effective on January 1, 2019, and will consist of an additional amount of common equity equal to 2.5% of risk-weighted assets.

The current capital rules require certain deductions from or adjustments to capital. The final rule retains many of these deductions and adjustments and also provides for new ones. As a result, deductions from Common Equity Tier 1 capital will be required for goodwill (net of associated deferred tax liabilities); intangible assets such as non-mortgage servicing assets and purchased credit card relationships (net of associated deferred tax liabilities); deferred tax assets that arise from net operating loss and tax credit carryforwards (net of any related valuations allowances and net of deferred tax liabilities); any gain on sale in connection with a securitization exposure; any defined benefit pension fund net asset (net of any associated deferred tax liabilities) held by a bank holding company (this provision does not apply to a bank or savings association); the aggregate amount of outstanding equity investments (including retained earnings) in financial subsidiaries; and identified losses. Other deductions will be necessary from different levels of capital.

Additionally, the final rule provides for the deduction of three categories of assets: (i) deferred tax assets arising from temporary differences that cannot be realized through net operating loss carrybacks (net of related valuation allowances and of deferred tax liabilities), (ii) mortgage servicing assets (net of associated deferred tax liabilities) and (iii) investments in more than 10% of the issued and outstanding common stock of unconsolidated financial institutions (net of associated deferred tax liabilities). The amount in each category that exceeds 10% of Common Equity Tier 1 capital must be deducted from Common Equity Tier 1 capital. The remaining, non-deducted amounts are then aggregated, and the amount by which this total amount exceeds 15% of Common Equity Tier 1 capital must be deducted from Common Equity Tier 1 capital. Amounts of minority investments in consolidated subsidiaries that exceed certain limits and investments in unconsolidated financial institutions may also have to be deducted from the category of capital to which such instruments belong.

Accumulated other comprehensive income (“AOCI”) is presumptively included in Common Equity Tier 1 capital and often would operate to reduce this category of capital. The final rule provides a one-time opportunity at the end of the first quarter of 2015 for covered banking organizations to opt out of much of this treatment of AOCI. The final rule also has the effect of increasing capital requirements by increasing the risk weights on certain assets, including high volatility commercial real estate, mortgage servicing rights not includable in Common Equity Tier 1 capital, equity exposures, and claims on securities firms, that are used in the denominator of the three risk-based capital ratios.

The ultimate impact of the rule on the Bank is currently being reviewed and is dependent upon when certain requirements of the rule will be fully phased in. While the rule contains several provisions that would affect the mortgage lending business, at this point we cannot determine the ultimate effect that the rule will have upon our earnings or financial position.

Volcker Rule. Section 619 of the Dodd-Frank Act, known as the “Volcker Rule,” prohibits any bank, bank holding company, or affiliate (referred to collectively as “banking entities”) from engaging in two types of activities: “proprietary trading” and the ownership or sponsorship of private equity or hedge funds that are referred to as “covered funds.” On December 10, 2013, our primary federal regulators, the Federal Reserve and the FDIC, together with other federal banking agencies and the SEC and the Commodity Futures Trading Commission, finalized a regulation to implement the Volcker Rule. The deadline for compliance with the Volcker Rule is July 21, 2015.

Proprietary trading includes the purchase or sale as principal of any security, derivative, commodity future, or option on any such instrument for the purpose of benefitting from short-term price movements or realizing short-term profits. Exceptions apply, however. Trading in U.S. Treasuries, obligations or other instruments issued by a government sponsored enterprise, state or municipal obligations, or obligations of the FDIC is permitted. A banking entity also may trade for the purpose of managing its liquidity, provided that it has a bona fide liquidity management plan. Trading activities as agent, broker or custodian; through a deferred compensation or pension plan; as trustee or fiduciary on behalf of customers; in order to satisfy a debt previously contracted; or in repurchase and securities lending agreements are permitted. Additionally, the Volcker Rule permits banking entities to engage in trading that takes the form of risk-mitigating hedging activities.

The covered funds that a banking entity may not sponsor or hold on ownership interest in are, with certain exceptions, funds that are exempt from registration under the Investment Company Act of 1940 because they either have 100 or fewer investors or are owned exclusively by “qualified investors” (generally, high net worth individuals or entities). Wholly owned subsidiaries, joint ventures and acquisition vehicles, foreign pension or retirement funds, insurance company separate accounts (including bank-owned life insurance), public welfare investment funds, and entities formed by the FDIC for the purpose of disposing of assets are not covered funds, and a bank may invest in them. Most securitizations also are not treated as covered funds.

The regulation as issued on December 10, 2013, treated collateralized debt obligations backed by trust preferred securities as covered funds and accordingly subject to divestiture. In an interim final rule issued on January 14, 2014, the agencies exempted collateralized debt obligations (“CDOs”) issued before May 19, 2010, that were backed by trust preferred securities issued before the same date by a bank with total consolidated assets of less than \$15 billion or by a mutual holding company and that the bank holding the CDO interest had purchased before December 10, 2013, from the Volcker Rule prohibition. This exemption does not extend to CDOs backed by trust-preferred securities issued by an insurance company.

Prompt Corrective Action. Federal law establishes a system of prompt corrective action to resolve the problems of undercapitalized banks. Under this system, the FDIC has established five capital categories (“well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized”) and is required to take various mandatory supervisory actions, and is authorized to take other discretionary actions with respect to banks in the three undercapitalized categories. The severity of any such actions taken will depend upon the capital category in which a bank is placed. Generally, subject to a narrow exception, current federal law requires the FDIC to appoint a receiver or conservator for a bank that is critically undercapitalized.

Under the FDIC’s prompt corrective action rules, a bank that (1) has a Total Capital Ratio of 10.0% or greater, a Tier 1 Capital Ratio of 6.0% or greater, and a Leverage Ratio of 5.0% or greater, and (2) is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the FDIC, is considered to be “well capitalized.” A bank with a Total Capital Ratio of 8.0% or greater, a Tier 1 Capital Ratio of 4.0% or greater, and a

Leverage Ratio of 4.0% or greater, is considered to be “adequately capitalized.” A bank that has a Total Capital Ratio of less than 8.0%, a Tier 1 Capital Ratio of less than 4.0%, or a Leverage Ratio of less than 4.0%, is considered to be “undercapitalized.” A bank that has a Total Capital Ratio of less than 6.0%, a Tier 1 Capital Ratio of less than 3.0%, or a Leverage Ratio of less than 3.0%, is considered to be “significantly undercapitalized,” and a bank that has a tangible equity capital to assets ratio equal to or less than 2.0% is deemed to be “critically undercapitalized.” For purposes of these rules, the term “tangible equity” includes core capital elements counted as Tier 1 Capital for purposes of the risk-based capital standards, plus the amount of outstanding cumulative perpetual preferred stock (including related surplus), minus all intangible assets (with various exceptions). A bank may be considered to be in a capitalization category lower than indicated by its actual capital position if it receives an unsatisfactory examination rating or is subject to a regulatory action that requires heightened levels of capital.

A bank that becomes “undercapitalized,” “significantly undercapitalized,” or “critically undercapitalized” is required to submit an acceptable capital restoration plan to the FDIC. An “undercapitalized” bank also is generally prohibited from increasing its average total assets, making acquisitions, establishing new branches, or engaging in any new line of business, except in accordance with an accepted capital restoration plan or with the approval of the FDIC. Also, the FDIC may treat an “undercapitalized” bank as being “significantly undercapitalized” if it determines that those actions are necessary to carry out the purpose of the law.

At December 31, 2013, all of the Bank’s capital ratios were at levels that would qualify it to be “well capitalized” for regulatory purposes.

As further described under “*Basel III Capital Standards*,” the Basel Committee released in June 2011 a revised framework for the regulation of capital and liquidity of internationally active banking organizations. The new framework is generally referred to as “Basel III”. As discussed above, when full phased in, Basel III will require certain bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity. On July 7, 2013, the Federal Reserve adopted a final rule implementing the Basel III standards and complementary parts of Basel II and Basel 2.5. On July 9, 2013, the OCC also adopted a final rule and the FDIC adopted the same provisions in the form of an “interim” final rule.

Powers of the FDIC in Connection with the Insolvency of an Insured Depository Institution. Under the FDIA, if any insured depository institution becomes insolvent and the FDIC is appointed as its conservator or receiver, the FDIC may disaffirm or repudiate any contract or lease to which the institution is a party which it determines to be burdensome, and the disaffirmance or repudiation of which is determined to promote the orderly administration of the institution’s affairs. The disaffirmance or repudiation of any of the Bank’s obligations would result in a claim of the holder of that obligation against the conservatorship or receivership. The amount paid on that claim would depend upon, among other factors, the amount of conservatorship or receivership assets available for the payment of unsecured claims and the priority of the claim relative to the priority of other unsecured creditors and depositors.

In its resolution of the problems of an insured depository institution in default or in danger of default, the FDIC generally is required to satisfy its obligations to insured depositors at the least possible cost to the deposit insurance funds. In addition, the FDIC may not take any action that would have the effect of increasing the losses to the deposit insurance funds by protecting depositors for more than the insured portion of deposits or creditors other than depositors. The FDIA authorizes the FDIC to settle all uninsured and unsecured claims in the insolvency of an insured bank by making a formal settlement payment after the declaration of insolvency as full payment and disposition of the FDIC’s obligations to claimants. The rate of the formal settlement payments will be a percentage rate determined by the FDIC reflecting an average of the FDIC’s receivership recovery experience.

Federal Deposit Insurance and Assessments. The Bank’s deposits are insured by the FDIC to the full extent provided in the FDIA, and the bank pays assessments to the FDIC for that insurance coverage. The Dodd-Frank Act established a permanent \$250,000 limit for federal deposit insurance coverage. The FDIC may terminate the Bank’s deposit insurance if it finds that the bank has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated applicable laws, regulations, rules or orders.

Under FDIA, the FDIC uses a revised risk-based assessment system to determine the amount of the Bank’s deposit insurance assessment based on an evaluation of the probability that the DIF will incur a loss with respect to the bank. That evaluation takes into consideration risks attributable to different categories and concentrations of the Bank’s assets and liabilities and any other factors the FDIC considers to be relevant, including information obtained from the Commissioner. A higher assessment rate results in an increase in the assessments the Bank pays to the FDIC for deposit insurance.

The FDIC is responsible for maintaining the adequacy of the DIF, and the amount the Bank pays for deposit insurance is influenced not only by the assessment of the risk it poses to the DIF, but also by the adequacy of the insurance fund at any time to cover the risk posed by all insured institutions. Because the DIF reserve ratio had fallen below the minimum level required by law, during 2008 the FDIC adopted a restoration plan to return the reserve ratio to the minimum level and, during 2009, it imposed a special assessment on insured institutions, increased regular assessment rates, and required that insured institutions prepay their regular quarterly assessments through 2012. More recently, as required by the Dodd-Frank Act, the FDIC has increased the minimum DIF reserve ratio to 1.35% which might be achieved by September 30, 2020. Although the Dodd-Frank Act requires the FDIC to offset the effect of the higher minimum ratio on insured depository institutions with assets of less than \$10 billion, FDIC insurance assessments could be increased substantially in the future if the FDIC finds such an increase to be necessary in order to adequately maintain the insurance fund.

Community Reinvestment. Under the Community Reinvestment Act (the “CRA”), an insured institution has a continuing and affirmative obligation, consistent with its safe and sound operation, to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for banks, nor does it limit a bank’s discretion to develop, consistent with the CRA, the types of products and services that it believes are best suited to its particular community. The CRA requires the federal banking regulators, in connection with their examinations of insured banks, to assess the banks’ records of meeting the credit needs of their communities, using the ratings of “outstanding,” “satisfactory,” “needs to improve,” or “substantial noncompliance,” and to take that record into account in its evaluation of various applications by those banks. All banks are required to publicly disclose their CRA performance ratings. The Bank received a “Satisfactory” rating in its most recent CRA examination.

Allowance for Loan and Lease Losses. The Allowance for Loan and Lease Losses (the “ALLL”) represents one of the most significant estimates in the Bank’s financial statements and regulatory reports. Because of its significance, the Bank has developed a system by which it develops, maintains, and documents a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses. The Interagency Policy Statement on the Allowance for Loan and Lease Losses, issued on December 13, 2006, encourages all banks to ensure controls are in place to consistently determine the ALLL in accordance with Generally Accepted Accounting Principles (“GAAP”), the Bank’s stated policies and procedures, management’s best judgment, and relevant supervisory guidance. Consistent with supervisory guidance, the Bank maintains a prudent and conservative, but not excessive, ALLL, that is at a level that is appropriate to cover estimated credit losses on individually evaluated loans determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. The Bank’s estimate of credit losses reflects consideration of all significant factors that affect the collectability of the portfolio as of the evaluation date.

Commercial Real Estate Lending. The Bank’s lending operations may be subject to enhanced scrutiny by federal banking regulators based on its concentration of commercial real estate loans. On December 6, 2006, the federal banking regulators issued final guidance to remind financial institutions of the risk posed by commercial real estate (“CRE”) lending concentrations. CRE loans generally include land development, construction loans, and loans secured by multifamily property, and non-farm, nonresidential real property where the primary source of repayment is derived from rental income associated with the property. The guidance prescribes the following guidelines for its examiners to help identify institutions that are potentially exposed to significant CRE risk, including concentrations in certain types of CRE that may warrant greater supervisory scrutiny:

total reported loans for construction, land development, and other land represent 100% or more of the institutions total capital, or

total commercial real estate loans represent 300% or more of the institution’s total capital, and the outstanding balance of the institution’s commercial real estate loan portfolio has increased by 50% or more.

Restrictions on Transactions with Affiliates. The Bank is subject to the provisions of Sections 23A and 23B of the Federal Reserve Act which restrict a bank's ability to enter into certain types of transactions with its "affiliates," including its parent holding company or any subsidiaries of its parent company. Among other things, Section 23A limits on the amount of:

- a bank's loans or extensions of credit to, or investment in, its affiliates;
- assets a bank may purchase from affiliates, except for real and personal property exempted by the Federal Reserve;
- the amount of loans or extensions of credit by a bank to third parties which are collateralized by the securities or obligations of the bank's affiliates; and

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a bank's guarantee, acceptance or letter of credit issued on behalf of one of its affiliates.

Transactions of the type described above are limited in amount, as to any one affiliate, to 10% of a bank's capital and surplus and, as to all affiliates combined, to 20% of a bank's capital and surplus. In addition to the amount limitations, each of the above transactions must also meet specified collateral requirements. The Bank also must comply with other provisions designed to avoid the taking of low-quality assets from an affiliate.

Section 23B, among other things, prohibits a bank or its subsidiaries generally from engaging in transactions with its affiliates unless the transactions are on terms substantially the same, or at least as favorable to the bank or its subsidiaries, as those prevailing at the time for comparable transactions with nonaffiliated companies.

Federal law also places restrictions on the Bank's ability to extend credit to its executive officers, directors, principal shareholders and their related interests. These extensions of credit:

· must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated third parties; and

· must not involve more than the normal risk of repayment or present other unfavorable features.

USA Patriot Act of 2001. The USA Patriot Act of 2001 (the "Patriot Act") strengthened the ability of U.S. law enforcement and the intelligence community to work cohesively to combat terrorism on a variety of fronts. The Patriot Act's impact on financial institutions has been significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and requires various regulations, including standards for verifying customer identification when accounts are opened, and rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Other Regulations. Interest and other charges collected or contracted for by the Bank are subject to state usury laws and federal laws concerning interest rates. Our loan operations will be subject to federal laws applicable to credit transactions, such as the:

· Federal Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;

· Home Mortgage Disclosure Act of 1975, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

· Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed, or other prohibited factors in extending credit;

· Fair Credit Reporting Act of 1978, as amended by the Fair and Accurate Credit Transactions Act, governing the use and provision of information to credit reporting agencies, certain identity theft protections, and certain credit and other disclosures;

· Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;

· Soldiers' and Sailors' Civil Relief Act of 1940, as amended by the Servicemembers' Civil Relief Act, governing the repayment terms of, and property rights underlying, secured obligations of persons currently on active duty with the United States military;

Talent Amendment in the 2007 Defense Authorization Act, establishing a 36% annual percentage rate ceiling, which includes a variety of charges including late fees, for consumer loans to military service members and their dependents; and

rules and regulations of the various federal banking regulators charged with the responsibility of implementing these federal laws.

The Bank's deposit operations are subject to federal laws applicable to depository accounts, such as:

- Truth-In-Savings Act, requiring certain disclosures of consumer deposit accounts;

Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

Electronic Funds Transfer Act and Regulation E issued by the Federal Reserve to implement that act, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services;

International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001, which sets forth anti-money laundering measures affecting insured depository institutions, broker-dealers, and other financial institutions; and

rules and regulations of the various federal banking regulators charged with the responsibility of implementing these federal laws.

Limitations on Senior Executive Compensation. In June 2010, federal banking regulators issued guidance designed to help ensure that incentive compensation policies at banking organizations do not encourage excessive risk-taking or undermine the safety and soundness of the organization. In connection with this guidance, the regulatory agencies announced that they will review incentive compensation arrangements as part of the regular, risk-focused supervisory process. Regulatory authorities may also take enforcement action against a banking organization if its incentive compensation arrangement or related risk management, control, or governance processes pose a risk to the safety and soundness of the organization and the organization is not taking prompt and effective measures to correct the deficiencies. To ensure that incentive compensation arrangements do not undermine safety and soundness at insured depository institutions, the incentive compensation guidance sets forth the following key principles:

incentive compensation arrangements should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose the organization to imprudent risk;

incentive compensation arrangements should be compatible with effective controls and risk management; and

incentive compensation arrangements should be supported by strong corporate governance, including active and effective oversight by the board of directors.

As the Company's Series A and Series B Preferred Stock was sold to unaffiliated third-party purchasers in March 2013, the Company is generally no longer subject to limitations on executive compensation pursuant to regulations issued as part of the TARP CPP.

Proposed Legislation and Regulatory Action. New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations, and competitive relationships of financial institutions operating and doing business in the United States. We cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which our business may be affected by any new regulation or statute.

Effect of Governmental Monetary Policies. The Bank's earnings are affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies. The Federal Reserve's monetary policies have had, and are likely to continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order, among other things, to curb inflation or combat a recession. The monetary policies of the Federal Reserve, including its ongoing "Quantitative Easing" program, affect the levels of bank loans, investments, and deposits through its control over the issuance of United States government securities, its regulation of the discount rate applicable to member banks, and its influence over reserve requirements to which member banks are subject. The Bank cannot predict the nature or impact of future changes in monetary and fiscal policies.

ITEM 1A. RISK FACTORS

An investment in our securities involves risks. If any of the following risks or other risks, which have not been identified or which we may believe are immaterial or unlikely, actually occurs, our business, financial condition, and results of operations could be harmed. In such a case, the value of our securities could decline, and you may lose all or part of your investment. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements.

Risks Related to the Company's Business

We may experience increased delinquencies and credit losses, which could have a material adverse effect on our capital, financial condition, and results of operations.

Like other lenders, we face the risk that our customers will not repay their loans. A customer's failure to repay us is usually preceded by missed monthly payments. In some instances, however, a customer may declare bankruptcy prior to missing payments, and, following a borrower filing bankruptcy, a lender's recovery of the credit extended is often limited. Since many of our loans are secured by collateral, we may attempt to seize the collateral when and if customers default on their loans. However, the value of the collateral may not equal the amount of the unpaid loan, and we may be unsuccessful in recovering the remaining balance from our customers. The resolution of nonperforming assets, including the initiation of foreclosure proceedings, requires significant commitments of time from management and our directors, which can be detrimental to the performance of their other responsibilities, and will expose the Company to additional legal costs and potential delays. Elevated levels of loan delinquencies and bankruptcies in our market area generally and among our customers specifically can be precursors of future charge-offs and may require us to increase our allowance for loan and lease losses. Higher charge-off rates, delays in the foreclosure process or in obtaining judgments against defaulting borrowers and an increase in our allowance for loan and lease losses may hurt our overall financial performance if we are unable to increase revenue to compensate for these losses and may also increase our cost of funds.

Our loan portfolio mix, which has loans secured by real estate, could result in increased credit risk in a challenging economy.

Our loan portfolio is concentrated in commercial real estate and commercial business loans. As of December 31, 2013, approximately 81.45% of our loans receivable were secured by real estate. These types of loans generally are viewed as having more risk of default than certain other types of loans or investments. In fact, the FDIC has issued pronouncements alerting banks of its concern about heavy loan concentrations in certain types of commercial real estate loans, including acquisition, construction and development loans, and also by geographic segment. Because our loan portfolio contains commercial real estate and commercial business loans with relatively large balances, the deterioration of one or a few of these loans may cause a significant increase in our non-performing loans. An increase in non-performing loans could result in a loss of earnings from these loans, an increase in the provision for loan losses, or an increase in loan charge-offs, any of which could have a material adverse impact on our results of operations and financial condition.

Any downturn in the economies or real estate values in the markets we serve could have a material adverse effect on both borrowers' ability to repay their loans and the value of the real property securing such loans. Our ability to recover on defaulted loans would then be diminished, and we would be more likely to suffer losses on defaulted loans.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could decrease.

Our success depends to a significant extent upon the quality of our assets, particularly loans. In originating loans, there is a substantial likelihood that we will experience credit losses. The risk of loss will vary with, among other

things, general economic conditions, the type of loan, the creditworthiness of the borrower over the term of the loan, and, in the case of a collateralized loan, the quality of the collateral for the loan.

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Our loan customers may not repay their loans according to the terms of these loans, and the collateral securing the payment of these loans may be insufficient to assure repayment. As a result, we may experience significant loan losses, which could have a material adverse effect on our operating results. Management makes various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. We maintain an allowance for loan losses in an attempt to cover any loan losses that may occur. In determining the size of the allowance, we rely on an analysis of our loan portfolio based on historical loss experience, volume and types of loans, trends in classification, volume and trends in delinquencies and non-accruals, national and local economic conditions, and other pertinent information.

If our assumptions are wrong, our current allowance may not be sufficient to cover future loan losses, and we may need to make adjustments to allow for different economic conditions or adverse developments in our loan portfolio. Material additions to our allowance would materially decrease our net income. We expect our allowance to continue to fluctuate throughout 2014; however, given current and future market conditions, we can make no assurance that our allowance will be adequate to cover future loan losses.

In addition, federal and state regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs, based on judgments different than those of our management. Any increase in our allowance for loan losses or loan charge-offs as required by these regulators could have a negative effect on our operating results.

The amount of other real estate owned (“OREO”) may increase significantly, resulting in additional losses, and costs and expenses that will negatively affect our operations.

At December 31, 2012, we had a total of \$15.29 million of OREO, and at December 31, 2013, we had a total of \$8.93 million of OREO, reflecting a \$6.35 million or 41.56% decrease from year-end 2012 to year-end 2013. During this period, sales and write downs were \$6.28 million and \$4.91 million, respectively, while properties acquired through foreclosures totaled \$4.83 million. Due to the ongoing economic crisis, the amount of OREO we hold may possibly increase throughout 2014. Any additional increase in losses and maintenance costs and expenses due to OREO may have material adverse effects on our business, financial condition, and results of operations. Such effects may be particularly pronounced in a market of reduced real estate values and excess inventory, which may make the disposition of OREO properties more difficult, increase maintenance costs and expenses, and may reduce our ultimate realization from any OREO sales. In addition, we are required to reflect the fair market value of our OREO in our financial statements. If the OREO declines in value, we are required to recognize a loss in connection with continuing to hold the property. As a result, declines in the value of our OREO have a negative effect on our results of operations and financial condition.

Our use of appraisals in deciding whether to make a loan on or secured by real property or how to value such loan in the future may not accurately describe the net value of the real property collateral that we can realize.

In considering whether to make a loan secured by real property, we generally require an appraisal of the property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is made, and, as real estate values in our market area have experienced changes in value in relatively short periods of time, this estimate might not accurately describe the net value of the real property collateral after the loan has been closed. If the appraisal does not reflect the amount that may be obtained upon any sale or foreclosure of the property, we may not realize an amount equal to the indebtedness secured by the property. In addition, we rely on appraisals and other valuation techniques to establish the value of our OREO and to determine certain loan impairments. If these valuations are inaccurate, our consolidated financial statements may not reflect the correct value of OREO, and our ALLL may not reflect accurate loan impairments. The valuation of the property may negatively impact the continuing value of such loan and could adversely affect our results of operations and financial condition.

If we are required to take a valuation allowance to our deferred tax asset in the future, our earnings and capital position may be adversely impacted.

Deferred income tax represents the tax impact of the differences between the book and tax basis of assets and liabilities. Deferred tax assets are assessed periodically by us to determine if they are realizable. Factors in our determination include the ability to carry back or carry forward net operating losses and the performance of the business including the ability to generate taxable income from a variety of sources and tax planning strategies. If, based on available information, it is more likely than not that the deferred income tax asset will not be realized, then a valuation allowance against the deferred tax asset must be established with a corresponding charge to income tax expense.

As of December 31, 2013, prior to any valuation allowance, deferred tax assets from operations totaled \$11.7 million and were recorded in the Company's Consolidated Balance Sheets. Based on our projections of future taxable income over the next three years, cumulative tax losses over the previous three years, net operating loss carry forward limitations as discussed below and available tax planning strategies, there remain deferred tax assets of \$0.7 million as of December 31, 2013. Analysis of our ability to recapture our deferred tax asset requires us to apply significant judgment and is inherently subjective because it requires the future occurrence of circumstances, including the projection of future earnings that cannot be predicted with certainty. The determination of how much of the net operating losses we will be able to utilize and, therefore, how much of the valuation allowance that may be reversed and the timing is based on our future results of operations and the amount and timing of actual loan charge-offs and asset writedowns. The resulting loss could have a material adverse effect on our results of operations and financial condition and could also decrease the Bank's regulatory capital.

Changes in the interest rate environment could reduce our net interest income, which could reduce our profitability.

As a financial institution, our earnings significantly depend on our net interest income, which is the difference between the interest income that we earn on interest-earning assets, such as investment securities and loans, and the interest expense that we pay on interest-bearing liabilities, such as deposits and borrowings. Therefore, any change in general market interest rates, including changes in federal fiscal and monetary policies, affects us more than non-financial institutions and can have a significant effect on our net interest income and total income. Our assets and liabilities may react differently to changes in overall market rates or conditions because there may be mismatches between the repricing or maturity characteristics of the assets and liabilities. As a result, an increase or decrease in market interest rates could have material adverse effects on our net interest margin and results of operations.

In addition, we cannot predict whether interest rates will continue to remain at present levels. Changes in interest rates may cause significant changes, up or down, in our net interest income. Depending on our portfolio of loans and investments, our results of operations may be adversely affected by changes in interest rates. In addition, any significant increase in prevailing interest rates could adversely affect our mortgage banking business because higher interest rates could cause customers to request fewer refinancings and purchase money mortgage originations.

We face strong competition from larger, more established competitors.

The banking business is highly competitive, and we experience strong competition from many other financial institutions. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds, and other financial institutions that operate in our primary market areas and elsewhere.

We compete with these institutions both in attracting deposits and in making loans, primarily on the basis of the interest rates we pay and yield on these products. In addition, we have to attract our customer base from other existing financial institutions and from new residents. Many of our competitors are well-established, much larger financial institutions. While we believe we can and do successfully compete with these other financial institutions in our markets, we may face a competitive disadvantage as a result of our smaller size and lack of geographic diversification. Further, should we fail to maintain an adequate volume of loans and deposits in accordance with our business strategy, it could have an adverse effect on our profitability in the future.

Although we compete by concentrating our marketing efforts in our primary market area with local advertisements, personal contacts, and greater flexibility in working with local customers, we can give no assurance that this strategy will be successful.

Hurricanes or other adverse weather events could negatively affect our local economies or disrupt our operations, which could have an adverse effect on our business or results of operations.

The economy of South Carolina's coastal region is affected, from time to time, by adverse weather events, particularly hurricanes. Our market area includes several coastal communities, and we cannot predict whether, or to what extent, damage caused by future hurricanes will affect our operations, our customers, or the economies in our banking markets. However, weather events could cause a disruption in our day-to-day business activities in branches located in coastal communities, a decline in loan originations, destruction or decline in the value of properties securing our loans, or an increase in the risks of delinquencies, foreclosures, and loan losses. Even if a hurricane does not cause any physical damage in our market area, a turbulent hurricane season could significantly affect the market value of all coastal property.

Our historical results may not be indicative of our future results.

Our growth prior to the current economic downturn may distort some of our historical financial ratios and statistics. In the future, we may not have the benefit of several favorable factors, such as a generally predictable interest rate environment, a strong residential mortgage market, or the ability to find suitable expansion opportunities. Various factors, such as economic conditions, regulatory and legislative considerations, and competition, may also impede or prohibit our ability to expand our market presence. If we are unable to achieve the rate of growth we established prior to the current economic downturn, our results of operations and financial condition may be adversely affected due to a high percentage of our operating costs being fixed expenses.

Our corporate culture has contributed to our success, and if we cannot maintain this culture as we grow, we could lose the teamwork and increased productivity fostered by our culture, which could harm our business.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters teamwork and increased productivity. As our organization grows and we are required to implement more complex organization management structures, we may find it increasingly difficult to maintain the beneficial aspects of our corporate culture. This could negatively impact our future success.

As a community bank, we have different lending risks than larger banks.

We provide services to our local communities. Our ability to diversify our economic risks is limited by our own local markets and economies. We lend primarily to individuals and to small- to medium-sized businesses, which may expose us to greater lending risks than those of banks lending to larger, better-capitalized businesses with longer operating histories.

We manage our credit exposure through careful monitoring of loan applicants and loan concentrations in particular industries, and through loan approval and review procedures. We have established an evaluation process designed to determine the adequacy of our allowance for loan losses. While this evaluation process uses historical and other objective information, the classification of loans and the establishment of loan losses is an estimate based on experience, judgment and expectations regarding our borrowers, and the economies in which we and our borrowers operate, as well as the judgment of our regulators. We cannot assure you that our loan loss reserves will be sufficient to absorb future loan losses or prevent a material adverse effect on our business, profitability or financial condition.

We are subject to liquidity risk in our operations.

Liquidity risk is the possibility of being unable, at a reasonable cost and within acceptable risk tolerances, to pay obligations as they come due, to capitalize on growth opportunities as they arise, or to pay regular dividends because of an inability to liquidate assets or obtain adequate funding on a timely basis. Liquidity is required to fund various obligations, including credit obligations to borrowers, mortgage originations, withdrawals by depositors, repayment of debt, dividends to stockholders, operating expenses, and capital expenditures. Liquidity is derived primarily from retail deposit growth and retention, principal and interest payments on loans and investment securities, net cash provided from operations, and access to other funding sources.

As of December 31, 2013, we had approximately \$23.0 million in brokered deposits, which represented approximately 8.14% of our total deposits. At times, the cost of brokered deposits exceeds the cost of deposits in our local market. In addition, the cost of brokered deposits can be volatile. In accordance with the Bank and Company MOUs, we are required to limit brokered deposits, excluding reciprocal CDARS, that would cause the Bank's level of brokered deposits to be in excess of ten percent of total deposits. This limitation, coupled with potential cost increases discussed above, could adversely affect our liquidity and ability to support demand for loans.

Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally affect our access to liquidity sources include a decrease in the level of our business activity due to a market downturn or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a severe disruption in the financial markets or negative views and expectations about the prospects for the financial services industry as a whole, given the recent turmoil faced by banking organizations in the domestic and worldwide credit markets. Currently, we have access to liquidity to meet our current anticipated needs; however, our access to additional borrowed funds could become limited in the future, and we may be required to pay above market rates for additional borrowed funds, if we are able to obtain them at all, which may adversely affect our results of operations.

The impact of the economic downturn on the performance of other financial institutions in our geographic area, actions taken by our competitors to address the current economic downturn, and the public perception of and confidence in the economy generally, and the banking industry specifically, could negatively impact our performance and operations.

All financial institutions are subject to the same risks resulting from a weakened economy such as increased charge-offs and levels of past due loans and nonperforming assets. As troubled institutions in our market area continue to recognize and dispose of problem assets, the already substantial inventory of residential homes and lots may negatively affect home values and increase the time it takes us or our borrowers to sell existing inventory. The perception that troubled banking institutions (and smaller banking institutions that are not “in trouble”) are risky institutions for purposes of regulatory compliance or safeguarding deposits may cause depositors nonetheless to move their funds to larger institutions. If our depositors should move their funds based on events happening at other financial institutions, our operating results would suffer.

A failure in or breach of our operational or security systems, or those of our third party service providers, including as a result of cyber attacks, could disrupt our business, result in unintentional disclosure or misuse of confidential or proprietary information, damage our reputation, increase our costs and cause losses.

As a financial institution, our operations rely heavily on the secure processing, storage and transmission of confidential and other information on our computer systems and networks. Any failure, interruption or breach in security or operational integrity of these systems could result in failures or disruptions in our online banking system, customer relationship management, general ledger, deposit and loan servicing and other systems. The security and integrity of our systems could be threatened by a variety of interruptions or information security breaches, including those caused by computer hacking, cyber attacks, electronic fraudulent activity or attempted theft of financial assets. We cannot assure you that any such failures, interruption or security breaches will not occur, or if they do occur, that they will be adequately addressed. While we have certain protective policies and procedures in place, the nature and sophistication of the threats continue to evolve. We may be required to expend significant additional resources in the future to modify and enhance our protective measures.

Additionally, we face the risk of operational disruption, failure, termination or capacity constraints of any of the third parties that facilitate our business activities, including exchanges, clearing agents, clearing houses or other financial intermediaries. Such parties could also be the source of an attack on, or breach of, our operational systems. Any failures, interruptions or security breaches in our information systems could damage our reputation, result in a loss of customer business, result in a violation of privacy or other laws, or expose us to civil litigation, regulatory fines or losses not covered by insurance.

Risks Related to the Company’s Regulatory Environment

We are subject to regulatory commitments that could have a material negative effect on our business, operating flexibility, financial condition, and the value of our securities. In addition, addressing these commitments will

require significant time and attention from our management team, which may increase our costs, impede the efficiency of our internal business processes, and adversely affect our profitability in the near-term.

The Bank entered into the Bank MOU with its primary regulators, the FDIC and the SC State Board, effective August 19, 2010. The Bank, the FDIC, and the SC State Board have agreed as to certain areas of the Bank's operations that warrant improvement and a plan for making those improvements. The Bank MOU requires the Bank to review and revise various policies and procedures, including those associated with concentration management, the allowance for loan and lease losses, liquidity management, criticized assets, credit administration, and capital.

Similarly, on the basis of the same examination by the FDIC and the SC State Board, the Federal Reserve Bank requested that the Company enter into the Company MOU; the Company entered into the Company MOU in December 2010. While the Company MOU provides for many of the same measures suggested by the Bank MOU, the Company MOU also requires that the Company seek pre-approval prior to the payment of dividends or other interest payments relating to its securities.

Until the Company is no longer subject to the Company MOU, it will be required to seek regulatory approval prior to paying scheduled dividends on its preferred stock and trust preferred securities, including the Series A Preferred Stock and Series B Preferred Stock issued to the Treasury as part of our participation in the TARP CPP and which is now held by unaffiliated third-party investors. This provision also applies to the Company's common stock, although, to date, the Company has not elected to pay a cash dividend on its shares of common stock. The Federal Reserve Bank has not approved the payment of dividends and interest relating to its outstanding classes of preferred stock and trust preferred securities due and payable since the third quarter of 2011. As a result, no assurance can be given as to when the Company will obtain approval from the Federal Reserve Bank to resume the payment of such dividends and interest in future quarters while the Company MOU remains in effect.

Further, should the Bank and/or the Company fail to comply with the provisions of each respective Memorandum, it could result in further enforcement actions by the FDIC, the Federal Reserve Bank, and/or the SC State Board. While we plan to take such actions as may be necessary to comply with the requirements of the memoranda, there can be no assurance that we will be able to comply fully with the provisions of either Memorandum, or that efforts to comply with the memoranda will not have adverse effects on the operations and financial condition of the Company and the Bank.

We are subject to extensive regulation that could limit or restrict our activities.

We operate in a highly regulated industry and are subject to examination, supervision, and comprehensive regulation by various regulatory agencies. Our compliance with these regulations, including compliance with our regulatory commitments, is costly and restricts certain of our activities, including the declaration and payment of cash dividends to common stockholders, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits, and locations of offices. We are also subject to capitalization guidelines established by our regulators, which require us to maintain adequate capital to support our growth and operations. Should we fail to comply with these regulatory requirements, federal and state regulators could impose additional restrictions on the activities of the Company and the Bank, which could materially affect our growth strategy and operating results in the future.

The laws and regulations applicable to the banking industry have recently changed and may continue to change, and we cannot predict the effects of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, our cost of compliance could adversely affect our ability to operate profitably.

The Dodd-Frank Act was enacted on July 21, 2010. The implications of the Dodd-Frank Act, or its implementing regulations, on our business are unclear at this time, but it may adversely affect our business, results of operations, and the underlying value of our common stock. The full effect of this legislation will not be even reasonably certain until implementing regulations are promulgated, which could take several years in some cases. See "Supervision and Regulation" for additional information.

Some or all of the changes, including the new rulemaking authority granted to the newly-created Consumer Financial Protection Bureau, may result in greater reporting requirements, assessment fees, operational restrictions, capital requirements, and other regulatory burdens for either, or both, the Bank and the Company, and many of our non-bank competitors may remain free from such limitations. This could affect our ability to attract and maintain depositors, to offer competitive products and services, and to expand our business.

Congress may consider additional proposals to substantially change the financial institution regulatory system and to expand or contract the powers of banking institutions and bank holding companies. Such legislation may change existing banking statutes and regulations, as well as our current operating environment significantly. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand our permissible activities, or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. We cannot predict whether new legislation will be enacted and, if enacted, the effect that it, or any regulations, would have on our business, financial condition, or results of operations.

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Our financial condition and results of operations are affected by credit policies of monetary authorities, particularly the Federal Reserve. Actions by monetary and fiscal authorities, including the Federal Reserve, could have an adverse effect on our deposit levels, loan demand, or business and earnings.

Rulemaking changes implemented by the CFPB will result in higher regulatory and compliance costs related to originating and servicing mortgages and may adversely affect our results of operations.

The CFPB recently has finalized a number of significant rules which will impact nearly every aspect of the lifecycle of a residential mortgage. These rules implement the Dodd-Frank Act amendments to the Equal Credit Opportunity Act, the Truth in Lending Act and the Real Estate Settlement Procedures Act. The final rules require banks to, among other things: (i) develop and implement procedures to ensure compliance with a new “reasonable ability to repay” test and identify whether a loan meets a new definition for a “qualified mortgage;” (ii) implement new or revised disclosures, policies and procedures for servicing mortgages including, but not limited to, early intervention with delinquent borrowers and specific loss mitigation procedures for loans secured by a borrower's principal residence; (iii) comply with additional restrictions on mortgage loan originator compensation; and (iv) comply with new disclosure requirements and standards for appraisals and escrow accounts maintained for “higher priced mortgage loans.”

While the rules generally affect banks our size somewhat less than larger financial institutions, our compliance with the new rule, and its accompanying enforcement by our federal and state regulators, will create operational and strategic challenges for us, as we originate a significant volume of mortgages. For example, business models for cost, pricing, delivery, compensation, and risk management will need to be reevaluated and potentially revised, perhaps substantially. Additionally, programming changes and enhancements to systems will be necessary to comply with the new rules. Some of these new rules became effective in June 2013, while others became effective in January 2014. Forthcoming additional rulemaking affecting the residential mortgage business is also expected. Achieving full compliance in the relatively short timeframe provided for certain of the new rules will result in increased regulatory and compliance costs.

New capital rules that were recently issued generally require insured depository institutions and certain bank holding companies to hold more capital. The impact of the new rules on our financial condition and operations is uncertain but could be materially adverse.

On July 2, 2013, the Federal Reserve adopted a final rule for the Basel III capital framework and, on July 9, 2013, the OCC also adopted a final rule and the FDIC adopted the same provisions in the form of an "interim final rule." These rules substantially amend the regulatory risk-based capital rules applicable to the Bank. The rules phase in over time beginning in 2015 and will become fully effective in 2019.

The final rules increase capital requirements and generally include two new capital measurements that will affect us, a risk-based common equity Tier 1 ratio and a capital conservation buffer. Common Equity Tier 1 (“CET1”) capital is a subset of Tier 1 capital and is limited to common equity (plus related surplus), retained earnings, accumulated other comprehensive income and certain other items. Other instruments that have historically qualified for Tier 1 treatment, including non-cumulative perpetual preferred stock, are consigned to a category known as Additional Tier 1 capital and must be phased out over a period of nine years beginning in 2014. The rules permit bank holding companies with less than \$15 billion in assets (such as us) to continue to include trust preferred securities and non-cumulative perpetual preferred stock issued before May 19, 2010 in Tier 1 capital, but not CET1. Tier 2 capital consists of instruments that have historically been placed in Tier 2, as well as cumulative perpetual preferred stock.

The final rules adjust all three categories of capital by requiring new deductions from and adjustments to capital that will result in more stringent capital requirements and may require changes in the ways we do business. Among other things, the current rule on the deduction of mortgage servicing assets from Tier 1 capital has been revised in ways that

are likely to require a greater deduction than we currently make and that will require the deduction to be made from CET1. This deduction phases in over a three-year period from 2015 through 2017. We closely monitor our mortgage servicing assets, and we expect to maintain our mortgage servicing asset at levels below the deduction thresholds by a combination of sales of portions of these assets from time to time either on a flowing basis as we originate mortgages or through bulk sale transactions. Additionally, any gains on sale from mortgage loans sold into securitizations must be deducted in full from CET1. This requirement phases in over three years from 2015 through 2017. Under the earlier rule and through 2014, no deduction is required.

Beginning in 2015, the minimum capital requirements for the Bank will be (i) a CET1 ratio of 4.5%, (ii) a Tier 1 capital (CET1 plus Additional Tier 1 capital) of 6% (up from 4%) and (iii) a total capital ratio of 8% (the current requirement). Our leverage ratio requirement will remain at the 4% level now required. Beginning in 2016, a capital conservation buffer will phase in over three years, ultimately resulting in a requirement of 2.5% on top of the CET1, Tier 1 and total capital requirements, resulting in a require CET1 ratio of 7%, a Tier 1 ratio of 8.5%, and a total capital ratio of 10.5%. Failure to satisfy any of these three capital requirements will result in limits on paying dividends, engaging in share repurchases and paying discretionary bonuses. These limitations will establish a maximum percentage of eligible retained income that could be utilized for such actions. While the final rules will result in higher regulatory capital standards, it is difficult at this time to predict when or how any new standards will ultimately be applied to us.

In addition to the higher required capital ratios and the new deductions and adjustments, the final rules increase the risk weights for certain assets, meaning that we will have to hold more capital against these assets. For example, commercial real estate loans that do not meet certain new underwriting requirements must be risk-weighted at 150%, rather than the current 100%. There are also new risk weights for unsettled transactions and derivatives. We also will be required to hold capital against short-term commitments that are not unconditionally cancelable; currently, there are no capital requirements for these off-balance sheet assets. All changes to the risk weights take effect in full in 2015.

In addition, in the current economic and regulatory environment, bank regulators may impose capital requirements that are more stringent than those required by applicable existing regulations. The application of more stringent capital requirements for us could, among other things, result in lower returns on equity, require the raising of additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Implementation of changes to asset risk weightings for risk-based capital calculations, items included or deducted in calculating regulatory capital or additional capital conservation buffers, could result in management modifying our business strategy and could limit our ability to make distributions, including paying dividends or buying back our shares.

The Federal Reserve may require us to commit capital resources to support the Bank.

The Federal Reserve requires a bank holding company to act as a source of financial and managerial strength to a subsidiary bank and to commit resources to support such subsidiary bank. Under the “source of strength” doctrine, the Federal Reserve may require a bank holding company to make capital injections into a troubled subsidiary bank and may charge the bank holding company with engaging in unsafe and unsound practices for failure to commit resources to such a subsidiary bank. In addition, the Dodd-Frank Act directs the federal bank regulators to require that all companies that directly or indirectly control an insured depository institution serve as a source of strength for the institution. Under these requirements, in the future, we could be required to provide financial assistance to our Bank if the Bank experiences financial distress.

A capital injection may be required at times when we do not have the resources to provide it, and therefore we may be required to borrow the funds. In the event of a bank holding company's bankruptcy, the bankruptcy trustee will assume any commitment by the holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank. Moreover, bankruptcy law provides that claims based on any such commitment will be entitled to a priority of payment over the claims of the holding company's general unsecured creditors, including the holders of its note obligations. Thus, any borrowing that must be done by the holding company in order to make the required capital injection becomes more difficult and expensive and will adversely impact the holding company's cash flows, financial condition, results of operations and prospects.

The FDIC Deposit Insurance assessments that we are required to pay may continue to materially increase in the future, which would have an adverse effect on our earnings.

As a member institution of the FDIC, we are assessed a quarterly deposit insurance premium. Failed banks nationwide have significantly depleted the insurance fund and reduced the ratio of reserves to insured deposits. As a result, we may be required to pay significantly higher premiums or additional special assessments that could adversely affect our earnings.

On October 19, 2010, the FDIC adopted a new DIF Restoration Plan, which requires the DIF to attain a 1.35% reserve ratio by September 30, 2020 and foregoes the uniform three basis point-increase scheduled to take effect on January 1, 2011. In addition, the FDIC modified the method by which assessments are determined and, effective April 1, 2011, adjusted assessment rates, which will range from 2.5 to 45 basis points (annualized), subject to adjustments for unsecured debt and, in the case of small institutions outside the lowest risk category and certain large and highly complex institutions, brokered deposits. Further increased FDIC assessment premiums, due to our risk classification, emergency assessments, or implementation of the modified DIF reserve ratio, could adversely impact our earnings.

We are subject to federal and state fair lending laws, and failure to comply with these laws could lead to material penalties.

Federal and state fair lending laws and regulations, such as the Equal Credit Opportunity Act and the Fair Housing Act, impose nondiscriminatory lending requirements on financial institutions. The Department of Justice, CFPB and other federal and state agencies are responsible for enforcing these laws and regulations. Private parties may also have the ability to challenge an institution's performance under fair lending laws in private class action litigation. A successful challenge to our performance under the fair lending laws and regulations could adversely impact our rating under the CRA and result in a wide variety of sanctions, including the required payment of damages and civil money penalties, injunctive relief, imposition of restrictions on merger and acquisition activity and restrictions on expansion activity, which could negatively impact our reputation, business, financial condition and results of operations.

The downgrade of the U.S. credit rating could negatively impact our business, results of operations and financial condition.

Recent U.S. debt ceiling and budget deficit concerns together with signs of deteriorating sovereign debt conditions in Europe, have increased the possibility of additional credit-rating downgrades and economic slowdowns in the U.S. Although U.S. lawmakers passed legislation to raise the federal debt ceiling in 2011, Standard & Poor's Ratings Services lowered its long-term sovereign credit rating on the U.S. from "AAA" to "AA+" in August 2011. This rating was affirmed in June 2013. The impact of any further downgrades to the U.S. government's sovereign credit rating or its perceived creditworthiness could adversely affect the U.S. and global financial markets and economic conditions. In February 2014, the U.S. government adopted legislation to suspend the debt limit through March 2015. Moody's and Fitch have each warned that they may downgrade the U.S. government's rating if the federal debt is not stabilized. A downgrade of the U.S. government's credit rating or a default by the U.S. government to satisfy its debt obligations likely would create broader financial turmoil and uncertainty, which would weigh heavily on the global banking system. It is possible that any such impact could have a material adverse effect on our business, results of operations and financial condition.

Failure to comply with government regulation and supervision could result in sanctions by regulatory agencies, civil money penalties, and damage to our reputation.

Our operations are subject to extensive regulation by federal, state, and local governmental authorities. Given the current disruption in the financial markets, we expect that the government will continue to pass new regulations and laws that will impact us. Compliance with such regulations may increase our costs and limit our ability to pursue business opportunities. Failure to comply with laws, regulations, and policies could result in sanctions by regulatory agencies, civil money penalties, and damage to our reputation. While we have policies and procedures in place that are designed to prevent violations of these laws, regulations, and policies, there can be no assurance that such violations will not occur.

Risks Relating to Ownership of Our Common Stock

Our ability to pay cash dividends on capital stock is limited and we may be unable to pay future dividends.

We make no assurances that we will pay any dividends in the future. Any future determination relating to dividend policy will be made at the discretion of our Board of Directors and will depend on a number of factors, including our future earnings, capital requirements, financial condition, future prospects, regulatory restrictions, and other factors that our Board of Directors may deem relevant. The holders of our capital stock are entitled to receive dividends when, and if, declared by our Board of Directors out of funds legally available for that purpose. As part of our consideration to pay cash dividends, we intend to retain adequate funds from future earnings to support the development and growth of our business. In addition, our ability to pay dividends is restricted by federal policies and regulations. It is the policy of the Federal Reserve Bank that bank holding companies should pay cash dividends on capital stock only out of net income available over the past year and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. Further, our principal source of funds to pay dividends is cash dividends that we receive from the Bank. In addition, pursuant to the Company MOU, we are prohibited from declaring and paying cash dividends without prior written approval from the Federal Reserve Bank.

Because we have participated in the TARP CPP, our ability to pay cash dividends on common stock is further limited. Specifically, we may not pay cash dividends on common stock unless all dividends have been paid on the securities issued to the Treasury under the TARP CPP. The TARP CPP also restricts our ability to increase the amount of cash dividends on common stock, which potentially limits your opportunity for gain on your investment. The Federal Reserve Bank has required us to defer payment of the dividends on our outstanding classes of preferred stock since the third quarter of 2011.

Finally, given the requirements under the Company MOU, we have been required by the Federal Reserve Bank to defer interest payments payable on our outstanding trust preferred securities. Accordingly, pursuant to the terms of the trust preferred securities, we are further restricted from paying dividends on our common stock and our outstanding classes of preferred stock, absent authorization from a majority of the holders of our outstanding trust preferred securities, until such time as the Company has paid all interest due and payable on the trust preferred securities.

The holders of shares of our various classes of preferred stock have rights that are senior to those of our common stockholders.

We have supported our capital operations by issuing two classes of preferred stock to the Treasury under the TARP CPP. These shares of Series A and Series B Preferred Stock were sold by the Treasury to unaffiliated third parties in March 2013.

Each outstanding class of preferred stock has dividend rights that are senior to our common stock; therefore, we must pay dividends on each class of preferred stock before we can pay any dividends on our common stock. In the event of our bankruptcy, dissolution, or liquidation, the holders of our preferred stock must be satisfied before we can make any distributions to our common stockholders.

Economic and other circumstances may require us to raise capital at times or in amounts that are unfavorable to us. If we have to issue shares of common stock, they will dilute the percentage ownership interest of existing shareholders and may dilute the book value per share of our common stock and adversely affect the terms on which we may obtain additional capital.

We may need to incur additional debt or equity financing in the future to make strategic acquisitions or investments or to strengthen our capital position. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at that time, which are outside of our control and our financial performance. We cannot provide assurance that such financing will be available to us on acceptable terms or at all, or if we do raise additional capital that it will not be dilutive to existing shareholders.

If we determine, for any reason, that we need to raise capital, our board generally has the authority, without action by or vote of the shareholders, to issue all or part of any authorized but unissued shares of stock for any corporate purpose, including issuance of equity-based incentives under or outside of our equity compensation plans. Additionally, we are not restricted from issuing additional common stock or preferred stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock or preferred stock or any substantially similar securities. The market price of our common stock could decline as a result of sales by us of a large number of shares of common stock or preferred stock or similar securities in the market or from the perception that such sales could occur. Any issuance of additional shares of stock will dilute the percentage ownership interest of our shareholders and may dilute the book value per share of our common stock. Shares we issue in connection with any such offering will increase the total number of shares and may dilute the economic and voting ownership interest of our existing shareholders.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not Applicable.

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ITEM 2. PROPERTIES

The executive and main offices of the Company and the Bank are located at 2170 West Palmetto Street in Florence, South Carolina. The facility at that location is owned by the Bank. The Bank also owns an adjacent lot that is used as a parking lot. The headquarters building is a two-story building having approximately 12,000 square feet. The building has six inside teller stations, two teller stations servicing four drive-through lanes, and a night depository and automated teller machine drive-through lane that is accessible after the Bank's normal business hours.

On April 26, 2000, the Bank opened a branch at 411 Second Loop Road in Florence, South Carolina. The Second Loop branch facility, which is owned by the Bank, is located on approximately one acre of land and contains approximately 3,000 square feet.

On May 15, 2002, the Bank purchased an additional facility located at 2145 Fernleaf Drive in Florence, South Carolina. The Fernleaf Drive site contains approximately 0.5 acres of land and includes a 7,500 square foot building. The facility serves as additional space for the operational and information technology activities of the Bank, including data processing and auditing. No customer services will be conducted in this facility.

On June 17, 2004, the Bank opened a temporary branch at 709 North Lake Drive in Lexington, South Carolina. On July 1, 2008, the bank subsequently moved into its permanent branch facility at 801 North Lake Drive in Lexington, South Carolina. The Lexington branch facility, which is leased by the Bank, is located on approximately two acres of land and contains approximately 13,000 square feet.

On March 15, 2005, the Bank opened a branch at 51 State Street, Charleston, South Carolina. This property is leased. On August 8, 2005, the Bank changed the street address of this location to 25 Cumberland Street, Charleston, South Carolina because of a change in the primary entrance to the branch.

On March 24, 2005, the Bank leased approximately five acres at 2211 West Palmetto Street in Florence, South Carolina for possible development of a future headquarters location. This property and an adjacent parcel were purchased by the Company on November 24, 2008 and are leased by the Bank. On March 15, 2012, the Company and the Bank agreed to waive the Bank's obligation to pay rent for the balance of 2013.

On October 3, 2005, the Bank opened a branch office at 800 South Shelmore Boulevard, Mount Pleasant, South Carolina. The Mount Pleasant branch facility is located on approximately one acre of land owned by the Company and contains approximately 6,500 square feet.

On February 9, 2006, the Bank purchased approximately 0.75 acres at 2148 West Palmetto Street, Florence, South Carolina for a future training facility. On April 1, 2007, the Bank opened its Learning Center which contains approximately 6,000 square feet.

The Bank owns property at 44th Business Park, Lots 1, 2, and 3, North Myrtle Beach, South Carolina, which was intended to be a branch site, but was never developed. This property is currently listed for sale.

In June 2007, the Bank entered into a lease for approximately 1.3 acres of land located at 5243 Forest Drive, Columbia, South Carolina. The Company anticipates that it will use this land as the site of a future branch office location.

In March 2008, the Bank purchased 1.37 acres at 8551 Rivers Avenue, North Charleston, South Carolina and one acre at 950 Lake Murray Boulevard, Columbia, South Carolina, which are expected to be future branch office locations.

On July 24, 2009, the Bank opened a branch office at 2805A Sunset Boulevard, West Columbia, South Carolina in a facility leased by the Bank.

Other than the Bank facilities described in the preceding paragraphs and the real estate-related loans funded by the Bank previously described in “Item 1. Business First Reliance Bank,” the Company does not invest in real estate, interests in real estate, real estate mortgages, or securities of or interests in persons primarily engaged in real estate activities.

ITEM 3. LEGAL PROCEEDINGS

As of December 31, 2013 and the date of this Form 10-K, we believe that we are not a party to, nor is any of our property the subject of, any pending material proceeding other than those that may occur in the ordinary course of our business, except for the proceeding described below.

On July 27, 2013, Gilbert Jarrell, in his individual capacity and on behalf of a proposed class of other similarly situated persons, filed a lawsuit in the Florence County Court of Common Pleas, Case No. 2013-CP-21-1701. The Complaint named the Bank as defendant. The Complaint alleges that plaintiff and other similarly situated persons who were clients of the Schurlknight and Rivers Law Firm ("S&R") were defrauded by S&R by settling claims without paying the plaintiffs their share of the settlement proceeds. Mr. Schurlknight committed suicide and Mr. Rivers has been indicted by the United States for mail fraud. S&R maintained its client trust account(s) with the Bank. The Plaintiffs claim that First Reliance aided and abetted S&R in the commission of many torts. The causes of action alleged are: aiding and abetting breach of fiduciary duty, aiding and abetting fraud, negligent supervision, breach of contract/third party beneficiary, negligence, and conversion. While the Bank is not able to predict the outcome of this lawsuit, it vehemently denies any wrongdoing or knowledge of any schemes by S&R to defraud the plaintiffs or any of the other former clients of S&R. The parties are currently engaged in the discovery process and a mediation of the matter has been scheduled. The plaintiffs in their complaint request \$6 million in damages and in subsequent correspondence have claimed damages of \$13 million.

ITEM 4.

MINE SAFETY DISCLOSURES

None.

PART II

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

The response to this Item is included in the Company's 2013 Annual Report to Shareholders under the heading, "Market for First Reliance Bancshares, Inc.'s Common Stock; Payment of Dividends," and is incorporated herein by reference.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data is derived from the consolidated financial statements and other data of First Reliance Bancshares, Inc. and Subsidiary (the "Company"). The selected financial data should be read in conjunction with the consolidated financial statements, including the accompanying notes, included elsewhere herein.

(Dollars in thousands, except per share data)	2013	2012	2011	2010	2009
Income Statement Data:					
Interest income	\$ 14,706	\$ 18,812	\$ 23,185	\$ 27,947	\$ 32,025
Interest expense	2,448	4,481	6,513	11,656	15,640
Net interest income	12,258	14,331	16,672	16,291	16,385
Provision for loan losses	610	1,946	5,403	3,542	14,401
Net interest income after provision for loan losses	11,648	12,385	11,269	12,749	1,984
Noninterest income	4,405	6,537	4,847	4,896	7,610
Noninterest expense	22,393	18,639	20,362	19,234	19,619
Income (loss) before income taxes	(6,340)	283	(4,246)	(1,589)	(10,025)
Income tax expense (benefit)	1,397	7	5,135	(1,440)	(4,181)
Net income (loss)	(7,737)	276	(9,381)	(149)	(5,844)
Preferred stock dividends	1,140	1,176	1,175	1,131	837
Net loss available to common shareholders	\$ (8,877)	\$ (900)	\$ (10,556)	\$ (1,280)	\$ (6,681)
Balance Sheet Data:					
Assets	\$ 355,408	\$ 418,277	\$ 494,966	\$ 530,095	\$ 645,508
Earning assets	306,242	362,518	435,214	468,618	589,657
Securities held-to-maturity ⁽¹⁾	36,952	-	-	-	-
Securities available-for-sale ⁽²⁾	12,145	60,071	84,534	84,473	121,949
Loans ⁽³⁾	240,750	265,879	306,262	355,514	411,728
Allowance for loan losses	2,894	4,167	7,743	6,271	9,801
Deposits	282,415	349,314	427,816	455,250	552,763
Shareholders' equity	39,093	41,198	41,118	48,592	45,224
Per Common Share Data:					
Basic loss	\$ (2.07)	\$ (0.22)	\$ (2.57)	\$ (0.32)	\$ (1.87)
Diluted loss	(2.07)	(0.22)	(2.57)	(0.32)	(1.87)
Common book value	3.56	5.64	5.67	7.49	8.36
Performance Ratios:					
Return on average assets ⁽⁴⁾	(2.02) %	0.06 %	(1.82) %	(0.03) %	(0.88) %
Return on average equity ⁽⁵⁾	(19.57) %	0.66 %	(19.97) %	(0.31) %	(12.14) %
Net interest margin ⁽⁶⁾	3.74 %	3.54 %	3.67 %	3.04 %	2.66 %
Efficiency ⁽⁷⁾	113.61 %	97.79 %	96.95 %	94.27 %	89.03 %
Capital and Liquidity Ratios:					
Average equity to average assets	10.31 %	9.08 %	9.09 %	8.19 %	7.28 %
Leverage (4.00% required minimum)	11.78 %	11.48 %	9.85 %	9.99 %	8.25 %
Risk-based capital					
Tier 1	14.73 %	15.91 %	13.54 %	13.34 %	11.52 %
Total	15.75 %	17.16 %	14.80 %	14.59 %	12.78 %
Average loans to average deposits	78.21 %	73.94 %	75.99 %	75.32 %	86.07 %

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- (1) Securities held-to-maturity are stated at cost.
- (2) Securities available-for-sale are stated at fair value.
- (3) Loans are stated at gross amounts before allowance for loan losses and include loans held for sale.
- (4) Net income (loss) before preferred stock dividends divided by average assets.
- (5) Net income (loss) before preferred stock dividends divided by average equity.
- (6) Net interest income divided by average earning assets.
- (7) Noninterest expense, less provision for losses on other real estate owned ("OREO"), divided by the sum of net interest income and noninterest income, excluding gains and losses on sales of assets.

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

Basis of Presentation

The following discussion should be read in conjunction with the preceding "Selected Financial Data" and the Company's consolidated financial statements and the notes thereto and the other financial data included elsewhere herein. The financial information provided below has been rounded in order to simplify its presentation. However, the ratios and percentages provided below are calculated using the detailed financial information contained in the consolidated financial statements, the notes thereto and the other financial data included elsewhere herein. Except where otherwise indicated, the "Company", "we", "us" and "our" refer to First Reliance Bancshares, Inc. and its wholly-owned subsidiary, First Reliance Bank.

General

First Reliance Bank (the "Bank") is a state-chartered bank headquartered in Florence, South Carolina. The Bank opened for business on August 16, 1999. The principal business activity of the Bank is to provide banking services to domestic markets, principally in Florence County, Lexington County, and Charleston County, South Carolina. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation (the "FDIC").

On June 7, 2001, the shareholders of the Bank approved a plan of corporate reorganization (the "Reorganization") under which the Bank would become a wholly owned subsidiary of First Reliance Bancshares, Inc. (the "Company"), a South Carolina corporation. The Reorganization was accomplished through a statutory share exchange between the Bank and the Company, whereby each outstanding share of common stock of the Bank was exchanged for one share of common stock of the Company. The Reorganization was completed on April 1, 2002, and the Bank became a wholly-owned subsidiary of the Company.

On June 30, 2005, First Reliance Capital Trust I (a non-consolidated affiliate) issued \$10,000,000 in trust preferred securities with a maturity of November 23, 2035 and may be redeemed by the Company after five years, and sooner in certain specific events. The rate was fixed at 5.93% until August 23, 2010, at which point the rate adjusts quarterly to the three-month LIBOR plus 1.83%, and can be called without penalty beginning on June 15, 2013. The trust has not been consolidated in these financial statements. The Company received from the trust the \$10,000,000 proceeds from the issuance of the securities and the \$310,000 initial proceeds from the capital investment in the trust, and accordingly has shown the funds due to the trust as \$10,310,000 junior subordinated debentures. Current regulations allow the entire amount of junior subordinated debentures to be included in the calculation of regulatory capital. On December 28, 2008, the Company injected \$3,000,000 into the Bank as permanent capital.

Results of Operations

For the years ended December 31, 2013 and 2012, we incurred a net loss available to common shareholders of \$8,876,633 and \$899,677, respectively, or a basic and diluted loss per common share of \$2.07 and \$0.22, respectively. Comparing 2013 with 2012, we experienced a reduction of \$7,976,956 in our operating results. This reduction is primarily attributable to the \$4,763,788 increase in our OREO expenses and the increase of \$1,390,249 in our income tax provision. Additionally, our 2013 operating results were negatively impacted by the declines in both our net interest income and noninterest income of \$2,073,431 and \$2,130,439, respectively. However, our operating

results for 2013 were favorably impacted by the \$737,378 reduction in our provision for loan losses. See the following for a detailed discussion of each of these items.

Net Interest Income

The largest component of our net income is net interest income, which is the difference between the income earned on assets and interest paid on deposits and on the borrowings used to support such assets. Net interest income is determined by the yields earned on our interest-earning assets and the rates paid on interest-bearing liabilities, the relative amounts of interest-earning assets and interest-bearing liabilities, and the degree of mismatch and the maturity and repricing characteristics of interest-earning assets and interest-bearing liabilities. The total interest-earning assets yield rate less the total interest-bearing liabilities rate represents our net interest rate spread.

Net interest income for 2013 was \$12,257,788 compared to \$14,331,219 for 2012, a decrease of \$2,073,431, or 14.47%. The decrease is due primarily to the significant reduction in the average volume of our loans, which are our highest yielding earning assets. Comparing 2013 with 2012, the average volume of our loans declined \$42,583,189, or 14.76%.

For 2013, average-earning assets totaled \$327,654,497 with an annualized average yield of 4.49% compared to \$404,631,999 and 4.65%, respectively, for 2012. Average interest-bearing liabilities totaled \$278,878,944 with an annualized average cost of 0.88% for 2013 compared to \$358,990,977 and 1.25% respectively, for 2012.

Our net interest margin and net interest spread were 3.74% and 3.61%, respectively, for 2013 compared to 3.54% and 3.40%, respectively, for 2012.

Because loans often provide a higher yield than other types of earning assets, one of our goals is to maintain our loan portfolio as the largest component of total earning assets. Loans comprised 75.08% and 71.32% of average earning assets for the years ended December 31, 2013 and 2012, respectively. Loan interest income for 2013 and 2012 was \$13,330,556 and \$16,419,908, respectively. The annualized average yield on loans was 5.42% and 5.69% for 2013 and 2012, respectively. Comparing 2013 with 2012, the average balances of our loans decreased \$42,583,189, or 14.76%, primarily reflecting relatively weak loan demand in our core markets, as well as consistent reductions in the level of our non-performing assets. Our loan interest income for 2013 was negatively affected by the significant decrease in the average volume of our loans and a slow recovery in our local real estate markets. Additional information may be found in the “Rate/Volume Analysis” presented below.

Available-for-sale and held-to-maturity-investment securities averaged \$53,407,855, or 16.30% of average earning assets, for 2013, compared to \$78,572,434, or 19.41% of average earning assets, for 2012. Comparing 2013 to 2012, the average balances were lower by \$25,164,579. During the third quarter of 2012, we significantly reduced our portfolio of municipal securities because of our concerns about the deterioration in their market bond ratings and to lower the credit risk associated with our securities portfolio. For 2013 and 2012, municipal securities averaged \$1,260,818 and \$12,995,104, respectively. It is our intention to invest primarily in U. S. Government-sponsored agency securities and mortgage-backed securities in the near future in order to avoid additional credit risk on relatively low yielding assets. Interest earned on available-for-sale and held-to-maturity investment securities was \$1,286,317 for 2013, compared to \$2,280,148 for 2012. The annualized average yield on these securities was 2.41% and 2.90% for 2013 and 2012, respectively. The decrease in yield was caused, in part, by a historically flat yield curve for investment securities that has diminished returns available for assets of this type.

Our average interest-bearing deposits were \$252,374,874 and \$332,611,848 for 2013 and 2012, respectively. This represented a decrease of \$80,236,974, or 24.12%. Total interest paid on deposits for 2013 and 2012 was \$2,023,326 and \$3,975,699, respectively. The annualized average cost of deposits was 0.80% and 1.20% for the years ended December 31, 2013 and 2012, respectively. As our loan demand declined, we concurrently lowered our rates paid for deposits, especially for time deposits, which is the primary reason why the amounts of our average time deposits were 36.34% lower during 2013 than during 2012.

The average balance of other interest-bearing liabilities was \$26,504,070 and \$26,379,179 for 2013 and 2012, respectively. This represented a slight increase of \$124,941, or 0.47%. With the diminished loan demand we experienced during the past year, we utilized fewer borrowings from the Federal Home Loan Bank and replaced them with securities sold under agreements to repurchase, which have a lower cost, to meet our funding needs. For 2013, the annualized average cost of borrowings from the Federal Home Loan Bank was 1.80% , whereas the annualized average cost of securities sold under agreements to repurchase was 0.10%.

Average Balances, Income and Expenses, and Rates - The following table sets forth, for the years indicated, certain information related to our average balance sheet and its average yields on assets and average costs of liabilities. Such yields are derived by dividing income or expense by the average balance of the corresponding assets or liabilities. Average balances have been derived from the daily balances throughout the periods indicated.

Year ended December 31,	Average Balances, Income and Expenses, and Rates								
	2013			2012			2011		
(Dollars in thousands)	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate
Assets									
Earning assets:									

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Loans ⁽¹⁾	\$ 246,000	\$ 13,331	5.42 %	\$ 288,584	\$ 16,420	5.69 %	\$ 332,893	\$ 19,895	5.
Securities, taxable	52,147	1,241	2.38	65,577	1,774	2.71	52,602	1,697	3.
Securities, nontaxable	1,261	45	3.57	12,995	506	3.89	34,724	1,491	4.
Other earning assets	28,246	89	0.32	37,476	112	0.30	33,957	102	0.
Total earning assets	327,654	14,706	4.49	404,632	18,812	4.65	454,176	23,185	5.
Non-earning assets	55,761			57,031			62,232		
Total assets	\$ 383,415			\$ 461,663			\$ 516,408		

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Year ended December 31, (Dollars in thousands)	Average Balances, Income and Expenses, and Rates								
	2013			2012			2011		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
Liabilities and Shareholders' Equity									
Interest-bearing deposits:									
Transaction accounts	\$ 44,727	\$ 47	0.11 %	\$ 42,148	\$ 80	0.19 %	\$ 39,010	\$ 175	0.45 %
Savings and money market accounts	95,043	161	0.17	113,568	351	0.31	120,897	849	0.70
Time deposits	112,605	1,815	1.61	176,896	3,545	2.00	228,093	5,176	2.27
Total interest-bearing deposits	252,375	2,023	0.80	332,612	3,976	1.20	388,000	6,200	1.60
Other interest-bearing liabilities:									
Federal Home Loan Bank borrowing									
Bank borrowing	11,230	202	1.80	12,503	263	2.10	18,296	275	1.50
Junior subordinated debentures	10,310	218	2.12	10,310	239	2.32	10,310	38	0.37
Other Borrowings	4,964	5	0.10	3,566	3	0.08	-	-	
Total other interest-bearing liabilities	26,504	425	1.60	26,379	505	1.91	28,606	313	1.09
Total interest-bearing liabilities	278,879	2,448	0.88	358,991	4,481	1.25	416,606	6,513	1.56
Noninterest-bearing deposits									
Other liabilities	62,174			57,675			50,086		
Shareholders' equity	2,823			3,065			2,750		
Total liabilities and equity	39,539			41,932			46,966		
	\$ 383,415			\$ 461,663			\$ 516,408		
Net interest income/interest spread									
		\$ 12,258	3.61 %		\$ 14,331	3.40 %		\$ 16,672	3.54 %
Net yield on earning assets									
			3.74 %			3.54 %			3.67 %

(1) Includes mortgage loans held for sale and nonaccruing loans

Rate/Volume Analysis of Interest Income

Analysis of Changes in Net Interest Income - Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following tables set forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

(Dollars in thousands)	2013 Compared to 2012			2012 Compared to 2011		
	Volume	Rate	Total	Volume	Rate	Total

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Interest income:						
Loans	\$ (2,338)	\$ (751)	\$ (3,089)	\$ (2,547)	\$ (928)	\$ (3,475)
Securities, taxable	(338)	(195)	(533)	378	(301)	77
Securities, tax exempt	(426)	(35)	(461)	(857)	(128)	(985)
Other earning assets	(30)	7	(23)	10	-	10
Total interest income	(3,132)	(974)	(4,106)	(3,016)	(1,357)	(4,373)
Interest expense:						
Interest-bearing deposits						
Interest-bearing transaction accounts	4	(37)	(33)	13	(108)	(95)
Savings and money market accounts	(50)	(140)	(190)	(49)	(449)	(498)
Time deposits	(1,126)	(604)	(1,730)	(1,066)	(565)	(1,631)
Total interest-bearing deposits	(1,172)	(781)	(1,953)	(1,102)	(1,122)	(2,224)
Other interest-bearing liabilities						
Federal Home Loan Bank borrowings	(25)	(36)	(61)	(102)	90	(12)
Junior subordinated debentures	-	(21)	(21)	-	201	201
Other	2	-	2	3	-	3
Total other interest-bearing liabilities	(23)	(57)	(80)	(99)	291	192
Total interest expense	(1,195)	(838)	(2,033)	(1,201)	(831)	(2,032)
Net interest income	\$ (1,937)	\$ (136)	\$ (2,073)	\$ (1,815)	\$ (526)	\$ (2,341)

Interest Sensitivity - We monitor and manage the pricing and maturity of our assets and liabilities in order to diminish the potential adverse impact that changes in interest rates could have on our net interest income. The principal monitoring technique we employed is the measurement of our interest sensitivity “gap,” which is the positive or negative dollar difference between assets and liabilities that are subject to interest rate repricing within a given period of time. Interest rate sensitivity can be managed by repricing assets or liabilities, selling securities available-for-sale, replacing an asset or liability at maturity, or adjusting the interest rate during the life of an asset or liability. Managing the amount of assets and liabilities repricing in this same time interval helps to hedge interest sensitivity and minimize the impact on net interest income of rising or falling interest rates.

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The following table sets forth our interest rate sensitivity at December 31, 2013.

(Dollars in Thousands)	Within One Month	After One Through Three Months	After Three Through Twelve Months	Within One Year	Greater Than One Year or Non- Sensitive	Total
Interest-Earning Assets						
Interest-bearing deposits in other banks	\$ 14,699	\$ -	\$ -	\$ 14,699	\$ -	\$ 14,699
Time deposits in other banks	-	-	101	101	-	101
Loans (1)	14,455	16,502	38,003	68,960	171,790	240,750
Securities, taxable	-	-	-	-	45,947	45,947
Securities nontaxable	-	-	-	-	3,150	3,150
Nonmarketable securities	1,595	-	-	1,595	-	1,595
Total earning assets	30,749	16,502	38,104	85,355	220,887	306,242
Interest-Bearing Liabilities						
Interest-bearing deposits:						
Demand deposits	\$ 46,046	\$ -	\$ -	\$ 46,046	\$ -	\$ 46,046
Savings deposits	86,247	-	-	86,247	-	86,247
Time deposits	9,136	16,910	36,708	62,754	21,791	84,545
Total interest-bearing deposits	141,429	16,910	36,708	195,047	21,791	216,838
Federal Home Loan Bank Advances	6,000	-	17,000	23,000	-	23,000
Junior subordinated debentures	-	-	-	-	10,310	10,310
Repurchase agreements	4,876	-	-	4,876	-	4,876
Total interest-bearing liabilities	152,305	16,910	53,708	222,923	32,101	255,024
Period gap	\$ (121,556)	\$ (408)	\$ (15,604)	\$ (137,568)	\$ 188,786	
Cumulative gap	\$ (121,556)	\$ (121,964)	\$ (137,568)	\$ (137,568)	\$ 52,218	
Ratio of cumulative gap to total earning assets	(39.69)	%	(39.83)	%	(44.92)	%
					16.72	%

(1) Including mortgage loans held for sale.

The above table reflects the balances of earning assets and interest-bearing liabilities at the earlier of their repricing or maturity dates. Interest-bearing deposits in other banks are reflected at the earliest pricing interval due to the immediate availability of the deposits. Securities are reflected at each instrument's ultimate maturity date. Scheduled payment amounts of fixed rate amortizing loans are reflected at each scheduled payment date. Scheduled payment

amounts of variable rate amortizing loans are reflected at each scheduled payment date until the loan may be repriced contractually; the unamortized balance is reflected at that point. Interest-bearing liabilities with no contractual maturity, such as demand deposits and savings deposits, are reflected in the earliest repricing period due to contractual arrangements, which give us the opportunity to vary the rates paid on those deposits within one month or shorter period. However, we are not obligated to vary the rates paid on these deposits within any given period. Fixed rate time deposits, primarily certificates of deposit, are reflected at their contractual maturity dates. Securities sold under agreements to repurchase agreements mature on a daily basis and are reflected in the earliest repricing period. Advances from the Federal Home Loan Bank and junior subordinated debentures are reflected at their contractual maturity date.

We are in a liability sensitive position (or a negative gap) of \$137.6 million over the 12-month time frame. The gap is negative when interest-bearing liabilities exceed interest sensitive earning assets, as was the case at the end of 2013, with respect to the one-year time horizon. When interest-sensitive earning assets exceed interest-bearing liabilities for a specific repricing "horizon," a positive interest sensitivity gap is the result.

A positive gap generally has a favorable effect on net interest income during periods of rising rates. A positive one-year gap position occurs when the dollar amount of earning assets maturing or repricing within one year exceeds the dollar amount of interest-bearing liabilities maturing or repricing during that same period.

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As a result, during periods of rising interest rates, the interest received on earning assets will increase faster than interest paid on interest-bearing liabilities, thus increasing interest income. The reverse is true in periods of declining interest rates resulting generally in a decrease in net interest income.

Asset/liability management is the process by which we monitor and control the mix and maturities of our assets and liabilities. The essential purposes of asset/liability management are to ensure adequate liquidity and to maintain an appropriate balance between interest sensitive assets and liabilities in order to minimize potentially adverse impacts on earnings from changes in market interest rates. We have an internal finance committee consisting of senior management that meets at various times during each quarter and a management finance committee that meets weekly as needed. The finance committees are responsible for maintaining the level of interest rate sensitivity of our interest sensitive assets and liabilities within a board-approved limit.

Our gap analysis is not a precise indicator of our interest rate sensitivity position. The analysis presents only a static view of the timing of maturities and repricing opportunities, without considering that changes in interest rates do not affect all assets and liabilities equally. For example, rates paid on a substantial portion of core deposits may change contractually within a relatively short time frame, but those rates are viewed by management as significantly less interest-sensitive than market-based rates such as those paid on non-core deposits. Net interest income may be impacted by other significant factors in a given interest rate environment, including changes in the volume and mix of earning assets and interest-bearing liabilities. We believe there would be minimal impact on interest income in a rising or falling rate environment.

Provision and Allowance for Loan Losses

We have policies and procedures for evaluating the overall quality of our credit portfolio and the timely identification of potential problem credits. On a quarterly basis, our Board of Directors reviews and approves the appropriate level for the allowance for loan losses based upon management's recommendations, the results of our internal monitoring and reporting system, and an analysis of economic conditions in our market. The objective of management has been to fund the allowance for loan losses at a level greater than or equal to our internal risk measurement system for loan risk.

Additions to the allowance for loan losses, which are expensed as the provision for loan losses on our statement of operations, are made periodically to maintain the allowance at an appropriate level based on management's analysis of the potential risk in the loan portfolio. Loan losses and recoveries are charged or credited directly to the allowance. The amount of the provision is a function of the level of loans outstanding, the level of nonperforming loans, historical loan loss experience, the amount of loan losses actually charged against the reserve during a given period, and current and anticipated economic conditions.

The allowance represents an amount which management believes will be adequate to absorb inherent losses on existing loans that may become uncollectible. Our judgment as to the adequacy of the allowance for loan losses is based on a number of assumptions about future events, which we believe to be reasonable, but which may or may not prove to be accurate. Our determination of the allowance for loan losses is based on regular evaluations of the collectability of loans, including consideration of factors such as the balance of impaired loans, the quality, mix, and size of our overall loan portfolio, economic conditions that may affect the borrower's ability to repay, the amount and quality of collateral securing the loans, our historical loan loss experience, and a review of specific problem loans. We also consider subjective issues such as changes in our lending policies and procedures, changes in the local and national economy, changes in volume or type of credits, changes in the volume or severity of problem loans, quality

of loan review and board of director oversight, concentrations of credit, and peer group comparisons.

More specifically, in determining our allowance for loan losses, we regularly review loans for specific and impaired reserves based on the appropriate impairment assessment methodology. Pooled reserves are determined using historical loss trends measured over a four-quarter average applied to risk rated loans grouped by Federal Financial Institutions Examination Council (“FFIEC”) call code and segmented by impairment status. The pooled reserves are calculated by applying the appropriate historical loss ratio to the loan categories. Impaired loans greater than a minimum threshold established by management are excluded from this analysis. The sum of all such amounts determines our pooled reserves. During 2012, we shortened the period over which we review historical losses from eight quarters to four in response to industry trends and conditions; the shorter loss history window is more in line with our peer group and tracks more closely the unusual market volatility of the past several years, making the provision estimate more responsive to current economic conditions. The historical loss factors utilized in our model have been updated as of the end of the fourth quarter 2013 to reflect losses realized through the end of third quarter 2013.

As noted above, we track our portfolio and analyze loans grouped by FFIEC call code categories. The first step in this process is to risk grade each loan in the portfolio based on one common set of parameters. These parameters include items like debt-to-worth ratio, liquidity of the borrower, net worth, experience in a particular field and other factors such as underwriting exceptions. Weight is also given to the relative strength of any guarantors on the loan.

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After risk grading each loan, we then segment the portfolio by FFIEC call code groupings, separating out substandard and impaired loans. The remaining loans are grouped into “performing loan pools.” The loss history for each performing loan pool is measured over a specific period of time to create a loss factor. The relevant look back period is determined by management, regulatory guidance, and current market events. The loss factor is then applied to the pool balance and the reserve per pool calculated. Loans deemed to be substandard but not impaired are segregated and a loss factor is applied to this pool as well. Loans are segmented based upon sizes as smaller impaired loans are pooled and a loss factor applied, while larger impaired loans are assessed individually using the appropriate impairment measuring methodology. Finally, five qualitative factors are utilized to assess economic and other trends not currently reflected in the loss history. These factors include concentration of credit across the portfolio, the experience level of management and staff, effects of changes in risk selection and underwriting practice, industry conditions and the current economic and business environment. A quantitative value is assigned to each of the five factors, which is then applied to the performing loan pools. Negative trends in the loan portfolio increase the quantitative values assigned to each of the qualitative factors and, therefore, increase the reserve. For example, as general economic and business conditions decline, this qualitative factor’s quantitative value will increase, which will increase the reserve requirement for this factor. Similarly, positive trends in the loan portfolio, such as improvement in general economic and business conditions, will decrease the quantitative value assigned to this qualitative factor, thereby decreasing the reserve requirement for this factor. These factors are reviewed and updated by our management committee on a regular basis to arrive at a consensus for our qualitative adjustments.

Periodically, we adjust the amount of the allowance based on changing circumstances. We recognize loan losses to the allowance and add subsequent recoveries back to the allowance for loan losses. In addition, on a quarterly basis, we informally compare our allowance for loan losses to various peer institutions; however, we recognize that allowances will vary, as financial institutions are unique in the make-up of their loan portfolios and customers, which necessarily creates different risk profiles and risk weighting of qualitative factors for the institutions. We would only consider further adjustments to our allowance for loan losses based on this peer review if our allowance was significantly different from our peer group. To date, we have not made any such adjustment. There can be no assurance that charge-offs of loans in future periods will not exceed the allowance for loan losses as estimated at any point in time or that provisions for loan losses will not be significant to a particular accounting period, especially considering the overall economic weakness in many of our market areas due to a slow recovery from the recent downturn.

Various regulatory agencies review our allowance for loan losses through their periodic examinations, and they may require additions to the allowance for loan losses based on their judgment and assumptions about the economic condition of our market and the loan portfolio at the time of their examinations. Our losses will undoubtedly vary from our estimates, and it is possible that charge-offs in future periods will exceed the allowance for loan losses as estimated at any point in time.

As of December 31, 2013 and 2012, the allowance for loan losses was \$2,894,153 and \$4,167,482, respectively, a decrease of \$1,273,329, or 30.55%, from the 2012 allowance, which reflects the significant reduction in all categories of our problem loans. As a percentage of total loans, the allowance for loan losses was 1.21% and 1.60% at December 31, 2013 and 2012, respectively. See the discussion regarding the provision expense and “Activity in the Allowance for Loan Losses” below for additional information regarding our asset quality and loan portfolio.

The provision for loan losses was \$609,808 and \$1,945,861 for 2013 and 2012, respectively. This represents a decrease of \$1,336,053, or 68.66%. Our analysis of the allowance for loan losses as of December 31, 2013 showed that our overall loss rates have been stabilizing over the past several allowance calculations and that our credit exposure in the Myrtle Beach market and the Charleston market, which were particularly hard-hit by the downturn in the real estate markets, is phasing out. The decline in our provision expense for 2013 is reflective of our efforts to aggressively reduce our exposure to these markets, and a reduction in our amount of construction loans on our books.

We believe the allowance for loan losses at December 31, 2013, is adequate to meet loan losses inherent in the loan portfolio and, as described earlier, we maintain the flexibility to adjust the allowance to respond to short-term and long-term trends in our local economy that are reflected in our loan portfolio.

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The following table sets forth certain information with respect to the Company's allowance for loan losses and the composition of charge-offs and recoveries for the five years ended December 31, 2013.

Allowance for Loan Losses