

FIRST RELIANCE BANCSHARES INC  
Form 10-K  
March 22, 2013

**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, 2012

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 29501**

*(Address of Principal Executive Offices)*

*(Zip Code)*

**(843) 656-5000**

*(Registrant's telephone number, including area code)*

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

**None**

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

**Common Stock, \$0.01 Par Value**

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

Yes  No

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

Yes  No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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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, 2012 was approximately \$11.0 million, based on the registrant's closing sales price of \$3.55 as reported on the Over-the Counter Bulletin Board on June 30, 2012. There were 4,095,271 shares of the registrant's common stock outstanding as of March 12, 2013.

**DOCUMENTS INCORPORATED BY REFERENCE**

<u>Document</u>	<u>Parts Into Which Incorporated</u>
Annual Report to Shareholders for the Year Ended December 31, 2012	Part II
Proxy Statement for the Annual Meeting of Shareholders to be held June 20, 2013	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 traded on the OTC Bulletin Board under the symbol “FSRL.” Information about the Company is available on our website at [www.firstreliance.com](http://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 137,885. Florence County, which covers approximately 805 square miles, is located in the eastern portion of South Carolina and is bordered by Darlington, Marlboro, Dillon, Williamsburg, Marion, Clarendon, Sumter, and Lee Counties. Florence County has a number of large employers, including, GE Healthcare, Honda, Nan Ya Plastics, ESAB, QVC US, 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 2011 of 267,129. The primary market area is the City of Lexington and the surrounding areas of Lexington County, South Carolina. Lexington County is centrally located in the Midlands of South Carolina just outside the capital city in Columbia and is bordered by Richland, Newberry, Saluda, Aiken, Orangeburg, and Calhoun Counties. Lexington County has a number of large employers, including, Westinghouse Electric Corporation, Michelin North America, Winnsboro Assembly Opera, Amick Farms, Inc., and Bose Corporation. Lexington County is a major transportation crossroads for the Midlands with I-26, I-77, and I-20 bordering or running through the county. The Columbia Metropolitan Airport is located in Lexington County, just 10 miles from the town of Lexington, and is the southeastern hub for the United Parcel Service. The principal components of the economy of Lexington County are the wholesale and retail trade sector, the manufacturing sector, the government sector, the services sector and the financial, insurance and real estate sector.

The United States Census Bureau estimates that in 2011, Charleston County had a population of 357,704 and the Metro Area had a population of 664,607. Charleston is located on the central and southern east coast surrounded by Berkeley and Dorchester counties. Major employers in the area include the United States Navy, the Medical University of South Carolina, Boeing and the Charleston Air Force Base.

## **Our Business Strategy**

First Reliance Bank, founded in 1999, is ranked in the top 25 banks in South Carolina based on total deposits. We have assets of approximately \$418 million, and employ over 100 associates. We serve the Pee Dee, Midlands, and Low Country regions of South Carolina and specialize in providing South Carolina business and consumer customers with a broad array of banking programs, products and services. The Bank is well known in its markets for exceptional customer service and incredible customer loyalty. We are also proud to be one of South Carolina's "Best Places to Work" companies.

## **Strategic Plan**

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

## **Our Business Model**

### **Creating Sustainable Company Value through Exceptional Customer Loyalty**

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

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

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

**Associate Promise**

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

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

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

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

## Customer Value Promise

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

- Incredible Experience
- Distinctive Programs
- Unmatched Convenience

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

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

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

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

## Market Strategy

We choose to operate in high-growth markets that have a high concentration of our targeted customer segments. Our goal is to obtain 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 them, 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, 2012, the Bank's internal lending limit to a single customer is approximately \$7.4 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, 2012, our allowance for loan losses equaled approximately 1.6% 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, 2012, the composition of our loan portfolio by category was approximately as follows :

Industry Categories	Percentage (%)
---------------------	----------------

Real estate secured	85.12	%
Commercial and industrial	11.24	%
Consumer loans	3.58	%
Other loans	0.06	%
Total	100	%

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

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



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

As of December 31, 2012, total loans secured by first or second mortgages on real estate comprised approximately 85.12% 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, 2012	Percentage of Total Loan Portfolio	
Residential 1-4 family	\$ 35,091,846	13.48	%
Multifamily	\$ 5,563,043	2.14	%
Commercial	\$ 122,309,917	47.00	%
Construction	\$ 31,985,532	12.29	%
Second mortgage	\$ 4,077,692	1.57	%
Equity lines of credit	\$ 22,502,339	8.65	%
<b>Total:</b>	\$ 221,530,369	85.12	%

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 2012, the Bank sold mortgage loans in a total amount of approximately \$41.5 million, or 28.65% 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 2012, of the 247 loans sold by the Bank, 57 were FHA or VA loans and 25 were State Housing Loans, compared to 2011 where, of the 232 loans sold by the Bank, 39 were FHA or VA loans and 49 were State Housing loans. Such loans represented 25.63% of the dollar volume or 33.20% of the total number of loans sold by the Bank in 2012.

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 \$1,197,853 in 2012.

**Commercial and Industrial.** As of December 31, 2012, \$29.3 million, or 11.24% 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, 2012, 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, 2012	Percentage of Total Loan Portfolio	
Individuals (household, personal, single pay, installment and other)	\$ 8,707,500	3.35	%
Individuals (household, family, personal credit cards and overdraft protection)	\$ 597,413	0.23	%
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, 2012, 36 banks and savings institutions operated 263 offices within Charleston, Florence, and Lexington Counties. All of these institutions aggressively compete for business in the Bank's market area. Some of these competitors have been in business for many years, have established customer bases, are larger than the Bank, have substantially higher lending limits than the Bank has and are able to offer certain services, including trust and international banking services, that the Bank is able to offer only through correspondents, if at all.

The Bank currently conducts business principally through its six branches in Charleston, Florence, and Lexington Counties, South Carolina. Based upon data available on the FDIC's website as of June 30, 2012, the Bank's total deposits ranked ninth among financial institutions in our market area, representing approximately 3.04% of the total

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deposits in our market area. The table below shows our deposit market share in the counties we serve according to data from the FDIC website as of June 30, 2012.

Market	Number of Branches	Our Market Deposits (in millions)	Total Market Deposits (in millions)	Ranking	Market Share Percentage
South Carolina (by county):					
Charleston County	2	\$ 50	\$ 7,780	18	0.64 %
Florence County	2	277	2,100	3	13.19
Lexington County	2	76	3,370	10	2.26
First Reliance Bank (statewide)	6	\$ 403	\$ 67,387	25	0.60 %

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, 2012, the Bank had 92 full-time employees and 19 part-time employees. The executive officers of the Company also serve as executive officers of and are compensated by the Bank. The Company has no employees.

## **Legal Proceedings**

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

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## SUPERVISION AND REGULATION

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

- how, when, and where we may expand geographically;
- into what product or service market we may enter;
- how we must manage our assets; and
- under what circumstances money may or must flow between the parent bank holding company and the subsidiary bank.

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

### The Company

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

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

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



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

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

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

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

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

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

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

**Support of Subsidiary Institutions.** Under Federal Reserve policy, we are expected to act as a source of financial strength for the Bank and to commit resources to support the Bank. In addition, pursuant to the Dodd-Frank Wall Street 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 \$1.3 million) prior to payment of any dividend or other distribution to holders of *pari passu* or junior stock, including the Company's Fixed Rate Cumulative Mandatorily Convertible Preferred Stock, Series C, and its 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 10.40%, and its total risk-based capital ratio was 15.72%, both as of year-end 2012.

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

**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 (i) all dividends for the securities purchased under the TARP CPP be paid before other dividends can be paid and (ii) the Treasury must approve any increases in common dividends for three years following the Treasury's investment.

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 did not approve the Company's request to pay dividends and interest payments relating to its outstanding classes of preferred stock and trust preferred securities due and payable in either the fourth quarter of 2011, during 2012, or the first quarter of 2013. Should the Company fail to pay scheduled dividends on its outstanding shares of Series A and Series B Preferred Stock, the holder of those shares is entitled to name two individuals to our board of directors. As a result, no assurance can be given as to the ability of the Company to 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 2013, 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 \$10.7 million of transaction accounts, but a bank must maintain reserves equal to 3.0% on aggregate balances between \$10.7 million and \$58.8 million, and reserves equal to 10.0% on aggregate balances in excess of \$58.8 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.

**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 ability to repay and qualified mortgage standards rules, as well as the mortgage servicing rules, are scheduled to become effective in January 2014. The escrow and loan originator compensation rules are scheduled to become effective in June 2013. A final rule integrating disclosures required by the Truth in Lending Act and the Real Estate Settlement and Procedures Act is expected later this year. 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.

***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 Proposals.** In June 2012, federal regulators issued proposed rules to implement the capital adequacy recommendations of the Basel Committee on Bank Supervision first proposed in December 2010. These proposals, which are known as “Basel III,” propose significant changes to the minimum capital levels and asset risk-weights for all banks, regardless of size, and bank holding companies with greater than \$500 million in assets. Among the many changes in these proposed rules, banks would be required to hold higher levels of capital, a significantly higher portion of which would be required to be Tier 1 capital. Further, beginning in 2016, the ability of a bank or bank holding company to declare and pay dividends or pay discretionary bonuses to certain executive officers would become limited should the bank or bank holding company fail to maintain a “capital conservation buffer” composed of Tier 1 common equity that is 2.5% greater than applicable minimum capital requirements. The proposed Basel III rules would also impose significant changes on the risk-weighting of many assets, including home mortgages with high loan to value ratios, certain acquisition, development and construction loans, and certain past due assets. Finally, the proposed rules would also prevent trust preferred securities from counting as Tier 1 capital for the issuer following a ten-year phase out ending in 2022. The comment period for the proposed rules closed in late October 2012, and federal regulators have indicated that implementation of the proposed Basel III rules will be delayed, and the substance of the proposals subject to potential revision.

**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, 2012, all of the Bank’s capital ratios were at levels that would qualify it to be “well capitalized” for regulatory purposes.

**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

- 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, 2012, approximately 85.12% 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.

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 2013; 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, 2011, we had a total of \$22.1 million of OREO, and at December 31, 2012, we had a total of \$15.29 million of OREO, reflecting a \$6.8 million or 30% decrease from year-end 2011 to year-end 2012. These increases/decreases in OREO are due, among other things, to the continued deterioration of the residential real estate market and the tightening of the credit market. As the amount of OREO increases, our losses, and the costs and expenses to maintain the real estate, likewise increase. Due to the ongoing economic crisis, the amount of OREO we hold may continue to increase throughout 2013. 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, 2012, prior to any valuation allowance, net deferred tax assets from operations totaled \$9.6 million 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, we recorded a \$7.5 million valuation allowance against the net deferred tax asset as of December 31, 2012. Analysis of our ability to realize the remaining deferred tax asset of approximately \$2.1 million 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, 2012, we had approximately \$57.9 million in brokered deposits, which represented approximately 16.57% 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, as well as the Series C Preferred Stock issued as part of a private offering in 2010. 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 did not approve the Company's request to pay dividends and interest payments relating to its outstanding classes of preferred stock and trust preferred securities due and payable in either the fourth quarter of 2011, during 2012 or the first quarter of 2013. As a result, no assurance can be given as to the ability of the Company to 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.

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 will be effective in June 2013, while others will be 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.

***We may be required to raise additional capital in the future, including through new increased minimum capital thresholds established by our regulators as part of their implementation of Basel III, but that capital may not be available when it is needed and could be dilutive to our existing stockholders, which could adversely affect our financial condition and results of operations.***

We are required by regulatory authorities to maintain adequate levels of capital to support our operations, and our federal and state regulators are considering new regulations, including, but not limited to, a proposal rulemaking by the Federal Reserve to implement Basel III capital and risk-weighting standards. This proposal, if implemented, would require financial institutions to maintain higher minimum capital ratios, and place a greater emphasis on common equity as a component of Tier 1 capital. Further, the proposed rules require higher risk-weights associated with many

types of loans, including residential mortgages and construction loans. In order to support the operations at the Bank, we may need to raise capital in the future. Our ability to raise capital, if needed, will depend in part on conditions in the capital markets at that time, which are outside our control. Accordingly, we cannot assure you of our ability to raise capital, if needed, on terms acceptable to us. If we cannot raise capital when needed, our ability to operate or further expand our operations could be materially impaired. In addition, if we decide to raise equity capital under such conditions, the interest of our stockholders could be diluted.

***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.

## **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. We have elected to defer payment of the dividends on our outstanding classes of preferred stock during the fourth quarter of 2011, all of 2012, and the first quarter of 2013.

Finally, given the requirements under the Company MOU, we have elected 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. Further, in 2010, we issued shares of our Series C preferred stock to other private shareholders primarily

domiciled in our primary market area, and these shares are subject to mandatory conversion to shares of the Company's common stock in 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.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not Applicable.

#### **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 feet 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 2012.

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 44<sup>th</sup> 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**

None.

**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**

(a) The response to this Item 5(a) is included in the Company's 2012 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.

(b) Not Applicable.

(c) Not Applicable.

**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.

**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.

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(Dollars in thousands, except per share data)	2012	2011	2010	2009	2008
<b>Income Statement Data:</b>					
Interest income	\$18,812	\$23,185	\$27,947	\$32,025	\$36,243
Interest expense	4,481	6,513	11,656	15,640	17,541
Net interest income	14,331	16,672	16,291	16,385	18,702
Provision for loan losses	1,946	5,403	3,542	14,401	4,935
Net interest income after provision for loan losses	12,385	11,269	12,749	1,984	13,767
Noninterest income	6,537	4,847	4,896	7,610	4,986
Noninterest expense	18,639	20,362	19,234	19,619	18,586
Income (loss) before income taxes	283	(4,246 )	(1,589 )	(10,025 )	167
Income tax expense (benefit)	7	5,135	(1,440 )	(4,181 )	(459 )
Net income (loss)	276	(9,381 )	(149 )	(5,844 )	626
Preferred stock dividends	1,176	1,175	1,131	837	-
Net income (loss) available to common shareholders	\$(900 )	\$(10,556 )	\$(1,280 )	\$(6,681 )	\$626
<b>Balance Sheet Data:</b>					
Assets	\$418,277	\$494,966	\$530,095	\$645,508	\$603,434
Earning assets	362,518	435,214	468,618	589,657	560,032
Securities available for sale <sup>(1)</sup>	60,071	84,534	84,473	121,949	76,311
Loans <sup>(2)</sup>	265,879	306,262	355,514	411,728	478,579
Allowance for loan losses	4,167	7,743	6,271	9,801	8,224
Deposits	349,314	427,816	455,250	552,763	461,135
Shareholders' equity	41,198	41,118	48,592	45,224	37,426
<b>Per Common Share Data:</b>					
Basic earnings (loss)	\$(0.22 )	\$(2.57 )	\$(0.32 )	\$(1.87 )	\$0.18
Diluted earnings (loss)	(0.22 )	(2.57 )	(0.32 )	(1.87 )	0.18
Common book value	5.64	5.67	7.49	8.36	10.65
<b>Performance Ratios:</b>					
Return on average assets <sup>(3)</sup>	0.06 %	(1.82 )%	(0.03 )%	(0.88 )%	0.11 %
Return on average equity <sup>(4)</sup>	0.66 %	(19.97 )%	(0.31 )%	(12.14 )%	1.65 %
Net interest margin <sup>(5)</sup>	3.54 %	3.67 %	3.04 %	2.66 %	3.40 %
Efficiency <sup>(6)</sup>	97.79 %	96.95 %	94.27 %	89.03 %	78.49 %
<b>Capital and Liquidity Ratios:</b>					
Average equity to average assets	9.08 %	9.09 %	8.19 %	7.28 %	6.43 %
Leverage (4.00% required minimum)	11.48 %	9.85 %	9.99 %	8.25 %	9.28 %
<b>Risk-based capital</b>					
Tier 1	15.91 %	13.54 %	13.34 %	11.52 %	10.73 %
Total	17.16 %	14.80 %	14.59 %	12.78 %	11.97 %
Average loans to average deposits	73.94 %	75.99 %	75.32 %	86.07 %	106.63 %

- (1) Securities available-for-sale are stated at fair value.
- (2) Loans are stated at gross amounts before allowance for loan losses and include loans held for sale.
- (3) Net income (loss) before preferred stock dividends divided by average assets.
- (4) Net income (loss) before preferred stock dividends divided by average equity.
- (5) Net interest income divided by average earning assets.
- (6) Noninterest expense 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”).

Organizing activities for the Bank began on November 23, 1998. Upon the completion of the application process with the South Carolina State Board of Financial Institutions for a state charter and with the FDIC for deposit insurance, the Bank issued 723,518 shares of common stock at a price of \$10.00 per share, resulting in capital totaling \$7,173,293, net of selling expenses of \$61,887.

The Bank began operations on August 16, 1999 at its temporary facility on West Palmetto Street in Florence, South Carolina. In June of 2000, the Bank moved into its headquarters at 2170 West Palmetto Street in Florence, South Carolina. The Bank also opened a banking office on Second Loop Road in Florence, South Carolina in April of 2001. 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 feet building. The facility serves as additional space for operational activities of the Bank, including data processing and auditing. No customer services are conducted in this facility.

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 November 12, 2002, the Company commenced a stock offering whereby a minimum of 125,000 shares and a maximum of 1,250,000 shares of common stock were offered to fund continued expansion. The offering price was \$8.00 per share. This was a best efforts offering conducted without an underwriter. The Company sold 1,007,430 shares resulting in additional capital of \$8,059,439 net of selling expenses of \$162,965, in the offering, which was completed in May 2003.

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, 2011. 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.

On March 6, 2009, the Company completed a transaction with the United States Treasury (“Treasury”) under the Troubled Asset Relief Program Capital Purchase Program (“TARP CPP”). Under the TARP CPP, the Company received \$15,225,312, net of expenses of \$123,688, in exchange for 15,349 and 767 shares of its Series A and Series B Cumulative Perpetual Preferred Stock, respectively. The preferred shares issued to the Treasury qualify as tier 1 capital for regulatory purposes.

On April 9, 2010, the Company issued 340,145 shares of its common stock at \$4.50 per share and 2,293 shares of its newly created Series C Preferred Stock at \$1,000 per share. The gross proceeds from the issuance and sale of these securities were \$3,832,208.

Like most financial institutions, the Company's profitability depends largely upon net interest income, which is the difference between the interest received on earning assets, such as loans and investment securities, and the interest paid on interest-bearing liabilities, principally deposits and borrowings. The Company's results of operations are also affected by the provision for loan losses; non-interest expenses, such as salaries, employee benefits, and occupancy expenses; and non-interest income, such as mortgage loan fees and service charges on deposit accounts.

Economic conditions, competition and federal monetary and fiscal policies also affect financial institutions. Lending activities are also influenced by regional and local economic factors, such as housing supply and demand, competition among lenders, customer preferences and levels of personal income and savings in our primary market area.

### **Recent Regulatory Events**

Following an examination of the Bank by the Federal Deposit Insurance Corporation (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 South Carolina Commissioner of Banks ("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, which the Company entered into in December 2010 (the "Company MOU"). While this agreement provides for many of the same measures suggested by the Memorandum already in place for the Bank, the Company MOU requires that the Company seek pre-approval from the Federal Reserve Bank prior to the declaration or 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 completed in 2010. This provision will also apply to the Company's common stock, although to date, the Company has not elected to pay 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; however, the Federal Reserve did not approve the Company's request to pay dividends and interest payments relating to its outstanding classes of preferred stock and trust preferred securities due and payable in the fourth quarter of 2011 and for the four quarters of 2012. Also, such approval was not granted for payments due in the first quarter of 2013. As a result, no assurance can be given as to the ability of the Company to 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. Should the Company not pay the dividend on its preferred stock held by the U. S. Treasury for six quarterly periods, the holder of the Company's Series A and Series B Preferred Stock will have the right to appoint up to two directors to the Company's board of directors. As of the first quarter of 2013, the Company has not paid dividends on any of its classes of preferred stock for six quarters.

In response to these regulatory matters, the Bank and the Company have taken various actions designed to improve our lending procedures, nonperforming assets, liquidity and capital position and other conditions related to our operations, which are more fully described in turn as part of this discussion. We believe that the successful completion of these initiatives will result in full compliance with our regulatory obligations with the FDIC, the SC State Board and the Federal Reserve Bank and position us well for stability and growth over the long term.

## Results of Operations

Compared to 2011, our 2012 operating results improved by \$9,656,468. For the years ended December 31, 2012 and 2011, we incurred a net loss available to common shareholders of \$899,677 and \$10,556,145, respectively. This resulted in basic and diluted loss per share of \$0.22 for 2012, compared to \$2.57 for 2011.

Our 2012 operating results were favorably impacted by the reduction of \$5,127,954 in our income tax expense, a \$3,457,555 in reduction our provision for loan losses and reducing our noninterest expenses by \$1,723,509. Additionally, our operating results were favorably impacted by the increase of \$1,689,047 in our noninterest income. However, the drop in our net interest income of \$2,341,110 offset these positive factors. 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 2012 was \$14,331,219 compared to \$16,672,329 for 2011, a decrease of \$2,341,110, or 14.04%. The decrease is due primarily to the significant reduction in the average volume of our loans, which are our highest yielding earning assets. Comparing 2012 with 2011, the average volume of our loans declined \$44,309,495, or 13.31%

For 2012, average-earning assets totaled \$404,631,999 with an annualized average yield of 4.65% compared to \$454,176,320 and 5.10%, respectively, for 2011. Average interest-bearing liabilities totaled \$358,990,977 with an annualized average cost of 1.25% for 2012 compared to \$416,606,673 and 1.56%, respectively, for 2011.

Our net interest margin and net interest spread were 3.54% and 3.40%, respectively, for 2012 compared to 3.67% and 3.54%, respectively, for 2011.

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 71.32% and 73.30% of average earning assets for the years ended December 31, 2012 and 2011, respectively. Loan interest income for 2012 and 2011 was \$16,419,908 and \$19,895,558, respectively. The annualized average yield on loans was 5.69% and 5.98% for 2012 and 2011, respectively. Average balances of our loans were \$288,583,527 for 2012 compared to \$332,893,022 for 2011, a decrease of \$44,309,495. Our loan interest income for 2012 was negatively affected by the significant decrease in the average volume of our loans and the continuation of the downturn in our local real estate markets. Additional information may be found in the "Rate/Volume Analysis" presented on the following page.

Available-for-sale investment securities averaged \$78,572,434, or 19.41% of average earning assets, for 2012 compared to \$87,326,051, or 19.23% of average earning assets for 2011. Interest earned on investment securities was \$2,280,148 for 2012, compared to \$3,187,768 for 2011. The annualized average yield on available-for-sale investment securities was 2.90% and 3.65% for 2012 and 2011, respectively. The decrease in yield on our available-for-sale investment securities was caused, in part, by a historically flat yield curve for investment yields that has diminished returns available for this asset type. Additional information relating to our management of the securities portfolio can be found in "Management Discussion and Analysis - Earning Assets - Available-for-Sale Securities."

Our average interest-bearing deposits were \$332,611,848 and \$388,000,423 for 2012 and 2011, respectively. This represented a decrease of \$55,388,575, or 14.28%. Total interest paid on deposits for 2012 and 2011 was \$3,975,699 and \$6,199,928, respectively. The annualized average cost of deposits was 1.20% and 1.60% for the years ended December 31, 2012 and 2011, 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 22.45% lower during 2012 than during 2011.

The average balance of other interest-bearing liabilities was \$26,379,179 and \$28,606,250 for 2012 and 2011, respectively. This represented a decrease of \$2,227,121, or 7.79%. The decrease is mainly attributable to the decrease in our average borrowings from the Federal Home Loan Bank. With the diminished loan demand we experienced during the past year, we utilized fewer borrowings from the Federal Home Loan Bank to meet our funding needs.

**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, (Dollars in thousands)	Average Balances, Income and Expenses, and Rates								
	2012			2011			2010		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
<b>Assets</b>									
<b>Earning assets:</b>									
Loans <sup>(1)</sup>	\$288,584	\$16,420	5.69 %	\$332,893	\$19,895	5.98 %	\$380,019	\$23,310	6.13 %
Securities, taxable	65,577	1,774	2.71	52,602	1,697	3.23	55,027	2,065	3.75
Securities, nontaxable	12,995	506	3.89	34,724	1,491	4.29	57,090	2,444	4.28
Other earning assets	37,476	112	0.30	33,957	102	0.30	43,126	127	0.30
Total earning assets	404,632	18,812	4.65	454,176	23,185	5.10	535,262	27,946	5.22
Non-earning assets	57,031			62,232			57,421		
Total assets	\$461,663			\$516,408			\$592,683		
<b>Liabilities and Shareholders' Equity</b>									
<b>Interest-bearing deposits:</b>									
Transaction accounts	\$42,148	\$80	0.19 %	\$39,010	\$175	0.45	\$38,849	\$193	0.50 %
Savings and money market accounts	113,568	351	0.31	120,897	849	0.70	107,663	1,194	1.11
Time deposits	176,896	3,545	2.00	228,093	5,176	2.27	313,823	8,797	2.80
Total interest-bearing deposits	332,612	3,976	1.20	388,000	6,200	1.60	460,335	10,184	2.21
<b>Other interest-bearing liabilities:</b>									
Federal Home Loan Bank borrowing	12,503	263	2.10	18,296	275	1.50	24,954	849	3.40
Junior subordinated debentures	10,310	239	2.32	10,310	38	0.37	10,310	620	6.01
Other Borrowings	3,566	3	0.08	-	-	-	805	2	0.25
Total other interest-bearing liabilities	26,379	505	1.91	28,606	313	1.09	36,069	1,471	4.08
Total interest-bearing liabilities	358,991	4,481	1.25	416,606	6,513	1.56	496,404	11,655	2.35
Noninterest-bearing deposits	57,675			50,086			44,194		
Other liabilities	3,065			2,750			3,540		
Shareholders' equity	41,932			46,966			48,545		
Total liabilities and equity	\$461,663			\$516,408			\$592,683		

Net interest income/interest spread	\$14,331	3.40 %	\$16,672	3.54 %	\$16,291	2.87 %
Net yield on earning assets		3.54 %		3.67 %		3.04 %

(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)	2012 Compared to 2011			2011 Compared to 2010		
	Due to increase (decrease)			Due to increase (decrease)		
	in			in		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Loans	\$(2,547)	\$(928 )	\$(3,475)	\$(2,852)	\$(563 )	\$(3,415)
Securities, taxable	378	(301 )	77	(88 )	(280 )	(368 )
Securities, tax exempt	(857 )	(128 )	(985 )	(959 )	6	(953 )
Other earning assets	10	-	10	(25 )	-	(25 )
Total interest income	(3,016)	(1,357)	(4,373)	(3,924)	(837 )	(4,761)
Interest expense:						
Interest-bearing deposits						
Interest-bearing transaction accounts	13	(108 )	(95 )	1	(19 )	(18 )
Savings and money market accounts	(49 )	(449 )	(498 )	134	(479 )	(345 )
Time deposits	(1,066)	(565 )	(1,631)	(2,139)	(1,482)	(3,621)
Total interest-bearing deposits	(1,102)	(1,122)	(2,224)	(2,004)	(1,980)	(3,984)
Other interest-bearing liabilities						
Federal Home Loan Bank borrowings	(102 )	90	(12 )	(186 )	(388 )	(574 )
Junior subordinated debentures	-	201	201	-	(582 )	(582 )
Other	3	-	3	(2 )	-	(2 )
Total other interest-bearing liabilities	(99 )	291	192	(188 )	(970 )	(1,158)
Total Interest Expense	(1,201)	(831 )	(2,032)	(2,192)	(2,950)	(5,142)
Net interest income	\$(1,815)	\$(526 )	\$(2,341)	\$(1,732)	\$2,113	\$381

***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.



The following table sets forth our interest rate sensitivity at December 31, 2012.

### Interest Sensitivity Analysis

<i>(Dollars in Thousands)</i>	Within One Month	After One Through Three Months	After Three Through Twelve Months	Within One Year	Greater Than One Year or Non- Sensitive	Total
<b>Assets</b>						
<b>Interest-earning assets</b>						
Interest-bearing deposits in other banks	\$35,170	\$-	\$-	\$35,170	\$-	\$35,170
Time Deposits in other banks	-	-	101	101	-	101
Loans (1)	58,387	18,465	77,131	153,983	111,896	265,879
Securities, taxable	-	-	-	-	60,071	60,071
Nonmarketable securities	1,297	-	-	1,297	-	1,297
<b>Total earning assets</b>	<b>94,854</b>	<b>18,465</b>	<b>77,232</b>	<b>190,551</b>	<b>171,967</b>	<b>362,518</b>
<b>Liabilities</b>						
<b>Interest-bearing liabilities</b>						
<b>Interest-bearing deposits:</b>						
Demand deposits	42,569	-	-	42,569	-	42,569
Savings deposits	104,031	-	-	104,031	-	104,031
Time deposits	13,374	24,733	67,576	105,683	39,008	144,691
<b>Total interest-bearing deposits</b>	<b>159,974</b>	<b>24,733</b>	<b>67,576</b>	<b>252,283</b>	<b>39,008</b>	<b>291,291</b>
Securities sold under agreements to repurchase	4,378	-	-	4,378	-	4,378
Federal Home Loan Bank advances	-	-	10,000	10,000	1,000	11,000
Junior subordinated debentures	-	-	-	-	10,310	10,310
<b>Total interest-bearing liabilities</b>	<b>164,352</b>	<b>24,733</b>	<b>77,576</b>	<b>266,661</b>	<b>50,318</b>	<b>316,979</b>
<b>Period gap</b>	<b>\$(69,498 )</b>	<b>\$(6,268 )</b>	<b>\$(344 )</b>	<b>\$(76,110 )</b>	<b>\$121,649</b>	
<b>Cumulative gap</b>	<b>\$(69,498 )</b>	<b>\$(75,766 )</b>	<b>\$(76,110)</b>	<b>\$(76,110 )</b>	<b>\$45,539</b>	
<b>Ratio of cumulative gap to total earning assets</b>	<b>(19.17 )%</b>	<b>(20.90 )%</b>	<b>(20.99 )%</b>	<b>(20.99 )%</b>	<b>12.56 %</b>	

(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 repricing 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 \$76.1 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 2012 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.

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.

However, 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 we have positioned ourselves to where there is minimal impact on interest income in a rising or falling rate environment.

## Provision and Allowance for Loan Losses

We have developed 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. We have 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 2012 to reflect losses realized through the end of third quarter 2012.



As we mentioned 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.

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, 2012 and 2011, the allowance for loan losses was \$4,167,482 and \$7,743,470, respectively, a decrease of \$3,575,988, or 46.18%, from the 2011 allowance. The decrease is partly due to the charge-off of certain borrowers against previously established allowances, which did not require the allowance to be replenished. As a percentage of total loans, the allowance for loan losses was 1.60% and 2.55% at December 31, 2012 and 2011, 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 \$1,945,861 and \$5,403,416 for 2012 and 2011, respectively. This represents a decrease of \$3,457,555, or 63.99%. Our analysis of the allowance for loan losses as of December 31, 2012 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 uptick in provision expense in 2012 is reflective of our efforts to aggressively reduce our exposure to these markets.

We believe the allowance for loan losses at December 31, 2012, is adequate to meet potential loan losses inherent in the loan portfolio and, as described earlier, to maintain the flexibility to adjust the allowance should our local economy and loan portfolio either improve or decline in the future.

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, 2012.

#### Allowance for Loan Losses

(Dollars in thousands)	2012	2011	2010	2009	2008
Total loans outstanding at end of year	\$260,257	\$303,398	\$354,328	\$406,627	\$468,990
Average loans outstanding	\$288,584	\$332,893	\$380,019	\$462,400	\$481,572
Balance of allowance for loan losses at beginning of year	\$7,743	\$6,271	\$9,801	\$8,224	\$5,271
Loans charged off:					
Real estate – construction	2,296	1,825	4,430	7,114	-
Real estate – residential	1,085	1,641	2,501	2,768	323
Real estate – nonresidential	1,825	538	1,879	1,429	813
Commercial and industrial	1,391	527	1,469	2,530	997
Consumer and other	29	39	116	446	235
Total loan charge-offs	6,626	4,570	10,395	14,287	2,368
Recoveries of previous loan charge-offs					
Real estate – construction	298	356	1,311	985	-
Real estate – residential	129	88	286	200	68
Real estate – nonresidential	54	70	1,123	190	254
Commercial	613	113	438	68	10
Consumer and other	10	12	165	20	54
Total recoveries	1,104	639	3,323	1,463	386
Net charge-offs	5,522	3,931	7,072	12,824	1,982
Provision for loan losses	1,946	5,403	3,542	14,401	4,935
Balance of allowance for loan losses at end of year	\$4,167	\$7,743	\$6,271	\$9,801	\$8,224
Ratios:					
Net charge-offs to average loans outstanding	1.91	% 1.18	% 1.86	% 2.77	% 0.41
Net charge-offs to loans at end of year	2.12	% 1.30	% 2.00	% 3.15	% 0.42
Allowance for loan losses to average loans	1.44	% 2.33	% 1.65	% 2.12	% 1.71
Allowance for loan losses to loans at end of year	1.60	% 2.55	% 1.77	% 2.41	% 1.75
Net charge-offs to allowance for loan losses	132.52	% 50.77	% 112.76	% 130.84	% 24.10
Net charge-offs to provision for loan losses	283.76	% 72.76	% 199.69	% 89.05	% 40.16

## Risk Elements in the Loan Portfolio and Nonperforming Assets

**Nonperforming Assets** - The following table shows the nonperforming assets for the five years ended December 31, 2012.

(Dollars in thousands)	2012	2011	2010	2009	2008
Loans over 90 days past due and still accruing	\$6	\$328	\$1,910	\$40	\$2,097
Loans on nonaccrual:					
Real estate construction	2,874	8,194	14,796	16,380	6,250
Real estate mortgage - residential	3,779	3,852	3,310	2,518	7,156
Real estate mortgage – nonresidential	12,354	9,437	1,001	6,322	5,417
Commercial	1,879	1,300	753	154	563
Consumer	88	2	6	32	206
Total nonaccrual loans	20,974	22,785	19,866	25,406	19,592
Total of nonperforming loans	20,980	23,113	21,776	25,446	21,689
Other nonperforming assets	15,290	22,136	14,669	8,954	380
Total nonperforming assets	\$36,270	\$45,249	\$36,445	\$34,400	\$22,069
Percentage of nonperforming assets to total assets	8.67 %	9.14 %	6.88 %	5.33 %	3.66 %
Percentage of nonperforming loans to total loans	8.06 %	7.62 %	6.15 %	6.26 %	4.62 %
Allowance for loan losses as a percentage of non-performing loans	19.86 %	33.50 %	28.80 %	38.52 %	37.92 %

**Loans over 90 days and still accruing** – As of December 31, 2012 and 2011 we had loans totaling \$5,729 and \$327,889, respectively, that were past due 90 days and still accruing interest. All loans are secured and included in our impaired loan classification at December 31, 2012 and 2011.

**Nonaccruing loans** - At December 31, 2012 and 2011, loans totaling \$20,973,813 and \$22,784,773, respectively, were in nonaccrual status. Generally, loans are placed on nonaccrual status if principal or interest payments become 90 days past due and/or we deem the collectability of the principal and/or interest to be doubtful. Generally, once a loan is placed in nonaccrual status, all previously accrued and uncollected interest is reversed against interest income, unless collection of interest accrued to date is expected. Interest income on nonaccrual loans is recognized on a cash basis when the ultimate collectability is no longer considered doubtful. Loans are returned to accrual status when the principal and interest amounts contractually due are brought current and future payments are reasonably assured. During 2012 and 2011 interest income recognized on nonaccrual loans was \$677,458 and \$467,797, respectively. If the nonaccrual loans had been accruing interest at their original contracted rates, interest income related to these nonaccrual loans would have been \$1,234,852 and \$984,248 for 2012 and 2011, respectively. All nonaccruing loans at December 31, 2012 and 2011 were included in our classification of impaired loans at those dates.

***Restructured Loans*** - In situations where, for economic or legal reasons related to a borrower's financial difficulties, a concession to the borrower is granted that we would not otherwise consider, the related loan is classified as a troubled debt restructuring ("TDR"). The restructuring of a loan may include the transfer of real estate collateral, either through the pledge of additional properties by the borrower or through a transfer to the Bank in lieu of foreclosures. Restructured loans may also include the borrower transferring to the Bank receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan, a modification of the loan terms, or a combination of the above.

At December 31, 2012 there were 52 loans classified as TDRs totaling \$15,155,121. Of the 52 loans, seven loans totaling \$3,128,542 were performing while 45 loans totaling \$12,026,579 were not performing. As of December 31, 2011 there were 37 loans classified as TDRs totaling \$7,258,698. Of the 37 loans, 15 loans totaling \$3,163,205 were performing while 22 loans totaling \$4,095,493 were not performing. All restructured loans resulted in either extended maturity or lowered rates and were included in the impaired loan balance. From December 31, 2011 to December 31, 2012, TDR loans increased by \$7,896,423 due to the increase in the volume of problem loans that were modified to enhance the borrowers' repayment ability. All restructured loans resulted in either extended maturity or lowered rates and were included in the impaired loan balance.

**Impaired loans** - At December 31, 2012, we had impaired loans totaling \$28,030,927 as compared to \$26,503,206 at December 31, 2011. Included in the impaired loans at December 31, 2011 were 14 borrowers that accounted for 79.85% of the total amount of the impaired loans at that date. These loans were primarily commercial real estate loans located in coastal South Carolina. Impaired loans, as a percentage of total loans, were 10.77% at December 31, 2012 as compared to 8.74% at December 31, 2011.

During 2012, the average investment in impaired loans was approximately \$27,532,000 as compared to approximately \$25,589,000 for 2011. Impaired loans with a specific allocation of the allowance for loan losses totaled \$8,704,008 and \$8,557,659 at December 31, 2012 and 2011, respectively. The amount of the specific allocation at December 31, 2012 and 2011 was \$524,109 and \$2,665,394, respectively.

The downturn in the real estate market that began in 2008 and continued into 2012 has resulted in an increase in loan delinquencies, defaults and foreclosures; however, we believe these trends are stabilizing as the liquidation prices for our OREO have stabilized for vertical construction, indicating some stabilization of demand in the real estate market in our market area. In some cases, the current economic downturn has resulted in a significant impairment to the value of our collateral and limits our ability to sell the collateral upon foreclosure at its appraised value. There is also risk that downward trends could continue at a higher pace. If real estate values further decline, it is also more likely that we would be required to increase our allowance for loan losses.

On a quarterly basis, we analyze each loan that is classified as impaired during the period to determine the potential for possible loan losses. This analysis is focused upon determining the then current estimated value of the collateral, local market condition, and estimated costs to foreclose, repair and resell the property. The net realizable value of the property is then computed and compared to the loan balance to determine the appropriate amount of specific reserve for each loan.

**Other nonperforming assets** – Other nonperforming assets consist of other real estate owned (“OREO”) that was acquired through foreclosure. OREO is carried at fair market value minus estimated costs to sell. Current appraisals are obtained at time of foreclosure and write-downs, if any, charged to the allowance for loan losses as of the date of foreclosure. On a regular basis, we reevaluate our OREO properties for impairment. Along with gains and losses on disposal, expenses to maintain such assets and subsequent changes in the valuation allowance are included in other noninterest expense.

As of December 31, 2012, we had OREO properties totaling \$15,289,991, geographically located in the following South Carolina areas – 68.75% in the Coastal area, 16.67% in the Columbia area and 14.58% in the Florence area. The combined nature of these properties is 85.1% commercial and 14.49% residential and other. While we are diligently trying to dispose of our OREO properties, the current low demand in our local real estate market affects our ability to do so in a timely manner without experiencing additional losses. Additionally, there can be no assurance that these properties can be sold for their carrying values.

From December 31, 2011 to December 31, 2012, due primarily to sales, OREO decreased \$6,845,930, or 30.93%. While OREO properties that consist of raw land continue to be difficult to sell, the majority of our OREO inventory with improvements is income producing, either through sale or interim leasing. This cash flow helps offset direct costs such as taxes and insurance, while offsetting opportunity cost during marketing. During 2012 and 2011, income earned on OREO was \$134,051 and \$86,893, respectively. OREO expense, net of income earned, for the years ended December 31, 2012 and 2011 was \$1,946,441 and \$2,469,772.

### **Noninterest Income and Expense**

**Noninterest Income** - The following table sets forth the primary components of noninterest income for the years ended December 31, 2012 and 2011.

	2012	2011
Service charges on deposit accounts	\$1,841,685	\$1,821,695
Gain on sale of mortgage loans	1,197,853	972,173
Income from bank owned life insurance	370,957	400,873
Other service charges, commissions and fees	975,143	852,684
Gain on sale of securities available-for-sale	1,806,414	516,582
Other income	344,137	283,135
Total noninterest income	\$6,536,189	\$4,847,142

For 2012 compared to 2011, noninterest income increased \$1,689,047, or 34.85%. The increase in our noninterest income is due primarily to the following items:

Gain on sale of securities available-for-sale increased \$1,289,832. During the third quarter of 2012, we sold our  
1. entire portfolio of municipal bonds due to concerns about the continued fiscal uncertainty with respect to the local and state governments that issued the debt underlying these investments.

Because of historically low mortgage rates in effect during 2012, we experienced an increase in the volume of  
2. homeowners refinancing their existing mortgages, which is the primary reason why the gain on the sale of mortgage loans increased \$225,680.

3. Other service charges, commissions and fees increased \$122,459. During 2012 we introduced a debit card rewards program that accounted for most of this increase.

***Noninterest Expense*** - The following table sets forth the primary components of noninterest expense for the years ended December 31, 2012 and 2011.

	2012	2011
Salaries and employee benefits	\$7,804,091	\$8,986,480
Net occupancy	1,463,448	1,480,073
Furniture and equipment	1,495,911	1,204,178
Advertising	151,298	239,952
Office supplies and printing	145,092	204,410
Computer supplies and software amortization	145,292	113,415
Telephone	302,039	273,702
Professional fees and services	975,780	1,025,660
Meetings and travel expenses	147,955	234,734
Supervisory fees and assessments	737,204	995,634
Debit and credit card expenses	683,691	480,726
Other real estate owned expenses	1,946,441	2,469,772
Mortgage loan expenses	1,028,240	1,090,922
Other	1,612,474	1,562,807
Total	\$18,638,956	\$20,362,465
Efficiency ratio	97.79	% 96.95 %

For the years ended December 31, 2012 and 2011, total noninterest expense totaled \$18,638,956 and \$20,362,465, respectively, equating to a decrease of \$1,723,509, or 8.46% for 2012 compared to 2011.

During the latter part of 2011, we performed a rigorous review of our expense categories. Based on this review, we implemented certain operational changes that resulted in the reduction in our noninterest expense for 2012. The largest reduction realized was \$1,182,389 in our expense for salaries and benefits. Included in this reduction is income of \$337,153 attributable to the cancellation of all stock appreciation rights outstanding at December 31, 2011, during the first quarter of 2012. Additional information regarding the cancellation of the stock appreciation rights is provided in Note 16 to our financial statements.

Our OREO expenses for 2012 were \$523,331 lower than they were for 2011. Expenses related to OREO encompass maintenance costs, marketing costs, property taxes, and other professional services. The decrease is partially attributable to the 30.93% reduction in the volume of our OREO. At December 31, 2012 and 2011, our OREO totaled \$15,289,991 and \$22,135,921, respectively. Also, during 2012, we received \$211,485 for reimbursements of OREO expenses from prior years.

Additionally, with the reduction in our deposit base, the cost of our Federal Deposit Insurance premiums was \$258,430 lower for 2012 compared to 2011.

The favorable factors mentioned above were offset by increases in the following noninterest expenses for 2012 compared to 2011.



1. Insurance expense was \$168,243 higher for 2012, compared to 2011. The increase is due to the expanded policy coverage and higher insurance premiums.

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2. Furniture and equipment expense for 2012 and 2011 was \$1,495,911 and \$1,204,178, respectively, which represents an increase of \$291,733. The increase is due to the recent outsourcing of our data processing and servers to a vendor. While we will have more processing costs in the future, we believe these costs will be offset by lower computer hardware and maintenance costs.

3. Debit and credit card expenses increased \$202,965 with the introduction of a debit card rewards program during 2012. We anticipate that this program will generate sufficient fee income to cover its related cost.

**Income Tax Provision** – For the years ended December 31, 2012 and 2011, our income tax provision consists of a tax expense of \$6,751 and \$5,134,705, respectively. In 2011, we increased our deferred tax assets valuation allowance by approximately \$7,150,000. This resulted in our having to record an income tax expense for 2011, although we had no pre tax income. For 2012, our income tax expense related to our pre-tax income was offset by a reversal of an equal amount of our valuation allowance for deferred tax assets, except for \$6,751 of state income taxes.

Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some or all of a deferred tax asset will not be realized. At December 31, 2012, we determined that only approximately \$2,092,837 of our deferred tax assets relating to continuing operations at that date will be realized in future periods.

#### Earning Assets

**Loans** - Loans, including loans held for sale, are the largest category of earning assets and typically provide higher yields than the other types of earning assets. Associated with the higher loan yields are the inherent credit and liquidity risks which management attempts to control and counterbalance. Loans averaged \$288,583,527 in 2012 compared \$332,893,022 in 2011, a decrease of \$44,309,495, or 13.31%. At December 31, 2012, total loans were \$265,879,194 compared to \$306,261,700 at December 31, 2011, a decrease of \$40,382,506, or 13.19%. Excluding loans held for sale, loans were \$260,257,334 at December 31, 2012 compared to \$303,398,403 at December 31, 2011, which equated to a decrease of \$43,141,069, or 14.22%. During 2012 we charged off loans totaling \$6,625,808 and foreclosed on loans totaling \$1,169,539, net of OREO sales that we financed, whereby the loan balances were transferred to other real estate owned. The remainder of this decrease is the result of the economic downturn in our markets and worldwide deleveraging that caused the volume of new loan customers and average loan balances carried by current customers to decrease.

The following table sets forth the composition of the loan portfolio, excluding loans held for sale, by category at the dates indicated and highlights the Company's general emphasis on all types of lending.



**Composition of Loan Portfolio****Expressed in dollars (in thousands)**

December 31,	2012	2011	2010	2009	2008
Real estate					
Construction	\$31,985	\$43,320	\$62,635	\$77,567	\$60,744
Residential:					
Residential 1 – 4 family	35,092	42,838	50,085	57,539	72,245
Multifamily	5,563	8,630	9,337	9,963	7,105
Second mortgages	4,078	4,504	4,783	4,747	4,990
Equity lines of credit	22,502	24,998	27,990	31,596	37,793
Total residential	67,235	80,970	92,195	103,845	122,133
Nonresidential	122,310	133,603	152,178	169,934	201,318
Total real estate loans	221,530	257,893	307,008	351,346	384,195
Commercial and industrial	29,256	36,465	40,857	45,887	70,878
Consumer	9,305	8,650	6,057	7,943	8,974
Other	166	390	406	1,452	4,943
Total loans	260,257	303,398	354,328	406,628	468,990
Allowance for loan losses	(4,167 )	(7,743 )	(6,271 )	(9,801 )	(8,224 )
Net loans	\$256,090	\$295,655	\$348,057	\$396,827	\$460,766

**Expressed in percentages**

December 31,	2012	2011	2010	2009	2008
Real estate					
Construction	12.29 %	14.28 %	17.68 %	19.08 %	12.95 %
Residential:					
Residential 1 – 4 family	13.48	14.12	14.14	14.15	15.40
Mutifamily	2.14	2.84	2.64	2.45	1.51
Second mortgages	1.56	1.49	1.34	1.17	1.07
Equity lines of credit	8.65	8.24	7.90	7.77	8.06
Total residential	25.83	26.69	26.02	25.54	26.04
Nonresidential	47.00	44.03	42.95	41.79	42.94
Total real estate loans	85.12	85.00	86.65	86.41	81.93
Commercial and industrial	11.24	12.02	11.53	11.28	15.11
Consumer	3.58	2.85	1.71	1.95	1.91
Other	0.06	0.13	0.11	0.36	1.05
Total loans	100.00%	100.00%	100.00%	100.00%	100.00%
Allowance for loan losses	1.60 %	2.55 %	1.77 %	2.41 %	1.75 %

In the context of this discussion, a “real estate mortgage loan” is defined as any loan, other than a loan for construction purposes, secured by real estate, regardless of the purpose of the loan. It is common practice for financial institutions in our market area to obtain a mortgage on the Borrower’s real estate when possible, in addition to any other available collateral. This real estate collateral is taken as security to reinforce the likelihood of the ultimate repayment of the loan and tends to increase management’s willingness to make real estate loans and, to that extent, also tends to increase the magnitude of the real estate loan portfolio component.

The largest component of our loan portfolio is real estate mortgage loans. At December 31, 2012, real estate mortgage loans totaled \$221,530,369 and represented 85.12% of the total loan portfolio, compared to \$257,893,735, or 85.00%, at December 31, 2011. This represents a decrease of \$36,363,366, or 14.10%, from the December 31, 2011 balance.

Residential mortgage loans totaled \$67,234,920 at December 31, 2012, and represented 25.83% of the total loan portfolio, compared to \$80,969,771 and 26.69%, respectively, at December 31, 2011. Residential real estate loans consist of first and second mortgages on single or multi-family residential dwellings.

Nonresidential mortgage loans, which include commercial loans and other loans secured by multi-family properties and farmland, totaled \$122,309,917 at December 31, 2012, compared to \$133,603,482 at December 31, 2011. This represents a decrease of \$11,293,565, or 8.45%, from the December 31, 2011 balance.

Real estate construction loans were \$31,985,532 and \$43,320,482 at December 31, 2012 and 2011, respectively, and represented 12.29% and 14.28% of the total loan portfolio, respectively.

Currently, the demand for all types of real estate loans in our market area is weak, largely because of a slow recovery from the recent recession that affected many businesses and individuals in our market area.

Commercial and industrial loans decreased \$7,209,531, or 19.77%, to \$29,255,564 at December 31, 2012, from \$36,465,095 at December 31, 2011. The decrease is mainly due to the economic downturn in our markets that caused the demand for these types of loans to decrease. At December 31, 2012 and 2011, commercial and industrial loans represented 11.24% and 12.02%, respectively, of the total loan portfolio.

Our loan portfolio is also comprised of consumer and other loans that totaled \$9,471,401 and \$9,039,573 at December 31, 2012 and 2011, respectively, and represented 3.64% and 2.98%, respectively, of the total loan portfolio.

Our loan portfolio reflects the diversity of our markets. The economies of our markets contain elements of medium and light manufacturing, higher education, regional health care, and distribution facilities. We expect our local economy to remain stable; however, due to the slow economic recovery in some of our markets, we do not expect any material growth in our loan portfolio in the near future. We do not engage in foreign lending.

The repayment of loans in the loan portfolio as they mature is also a source of liquidity for the Company. The following table sets forth the Company's loans maturing within specified intervals at December 31, 2012.

#### Loan Maturity Schedule and Sensitivity to Changes in Interest Rates

(Dollars in thousands)	One Year or Less	Over One Year	Over Five Years	Total
		Through Five Years		
Commercial and industrial	\$15,034	\$14,222	\$-	\$29,256
Real estate	78,069	118,787	24,674	221,530
Consumer and other	1,951	6,541	979	9,471
	\$95,054	\$139,550	\$25,653	\$260,257

Loans maturing after one year with:

Fixed interest rates	\$ 111,896
Floating interest rates	53,307
	\$ 165,203

The information presented in the table above is based on the contractual maturities of the individual loans, including loans which may be subject to renewal at their contractual maturity. Renewal of such loans is subject to review and credit approval as well as modification of terms upon maturity. Consequently, we believe this treatment presents fairly the maturity and repricing structure of the loan portfolio.

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**Investment Securities** - The investment securities portfolio is also a component of our total earning assets. Our investment securities portfolio consists of securities available-for-sale and nonmarketable equity securities.

**Available-for-Sale Securities**

At December 31, 2012 our investment in available-for-sale securities was \$60,071,012. This is \$24,463,306, or 28.94%, lower than our investment of \$84,534,318 in available-for-sale securities at December 31, 2011. During the third quarter of 2012, we sold our entire 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. It is our intention to only invest in U. S. Government agencies and mortgage-backed securities in the near future.

This portfolio is primarily utilized to provide liquidity sources, flexibility, and balanced yielding assets to our balance sheet.

The amortized costs and the fair value of our securities available-for-sale at December 31, 2012 and 2011 are shown in the following table.

	December 31, 2012		December 31, 2011	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Government sponsored enterprises	\$7,591,892	\$8,109,028	\$2,839,706	\$3,024,945
Mortgage-backed securities	50,197,908	51,956,484	59,748,500	61,560,402
Municipal securities	-	-	19,084,899	19,937,971
Other	100,000	5,500	100,000	11,000
Total	\$57,889,800	\$60,071,012	\$81,773,105	\$84,534,318

At December 31, 2012, securities classified as available-for-sale are recorded at fair market value. The entire amount of the unrealized losses is the result of a single security in a continuous loss position for twelve months or more. We do not intend to sell this security in the near future and it is more likely than not that we will not be required to sell this security before recovery of its amortized cost. Based on industry analyst reports and credit ratings, we believe that the deterioration in value is not considered other-than-temporary.

**Available-for-Sale Securities Maturity Distribution and Yields (1)**



U.S Government  
Sponsored  
Enterprises

(Dollars in thousands)	Amount	Yield
Due after ten years	\$8,109	3.24 %

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(1) Excludes mortgage-backed securities totaling \$51,956,484 with a yield of 3.17% and an equity security in the amount \$5,500.

Other attributes of the securities portfolio, including yields and maturities, are discussed above in “Net Interest Income-Interest Sensitivity Analysis.”

***Nonmarketable Equity Securities*** – Nonmarketable equity securities are recorded at their original cost since no ready market exists for these securities. At December 31, 2012 and 2011, nonmarketable equity securities consisted of Federal Home Loan Bank and Community Bankers Bank stock, which are recorded at their original cost of \$1,239,300 and \$58,100, respectively and \$2,373,700 and \$58,100, respectively. These securities are held primarily as a pre-requisite for accessing liquidity sources provided by the issuers of these securities.

***Interest-Bearing Deposits with Other Banks*** – At December 31, 2012 and 2011, interest-bearing deposits with other banks totaled \$35,169,883 and \$41,885,966, respectively. For the years 2012 and 2011, the average balance of these deposits was \$35,566,257 and \$30,278,389, respectively.

## Deposits and Other Interest-Bearing Liabilities

Average interest-bearing liabilities decreased \$57,615,696, or 13.83%, to \$358,990,977 in 2012, from \$416,606,673 in 2011.

**Deposits** - Average total deposits decreased \$47,799,574, or 10.91%, to \$390,287,155 in 2012, from \$438,086,729 in 2011. At December 31, 2012, total deposits were \$349,314,134 compared to \$427,816,497 a year earlier, a decrease of \$78,502,363, or 18.35%.

Average interest-bearing deposits decreased \$55,388,575, or 14.28%, to \$332,611,848 in 2012 from \$388,000,423 in 2011. The average balance of non-interest bearing deposits increased \$7,589,001, or 15.15%, to \$57,675,307 in 2012, from \$50,086,306 in 2011.

The following table sets forth the average balance amounts and the average rates paid by us for the years ended December 31, 2012 and 2011.

### Deposits

	2012		2011	
	Average Amount	Average Rate	Average Amount	Average Rate
Noninterest bearing demand deposits	\$57,675,307	0.00	% \$50,086,306	0.00
Interest bearing demand deposits	42,147,971	0.19	39,010,399	0.45
Savings accounts	113,567,690	0.31	120,897,134	0.70
Time deposits	176,896,187	2.00	228,092,890	2.27
Total	\$390,287,155	1.02	% \$438,086,729	1.42

Core deposits, which exclude time deposits of \$100,000 or more, provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were \$265,610,288 and \$305,342,295 at December 31, 2012 and 2011, respectively. As of December 31, 2012 and 2011, our core deposits were 76.04% and 71.37% of total deposits, respectively. Overall, we have placed a high priority on securing low-cost local deposits over other, more costly, funding sources in the current low-rate environment.

Included in time deposits \$100,000 and over, at December 31, 2012 and 2011 are brokered time deposits of \$57,885,000 and \$90,860,000, respectively, equating to a decrease of \$32,975,000. In accordance with our asset/liability management strategy, we do not intend to renew or replace the brokered deposits outstanding at December 31, 2012, when they mature.

Deposits, and particularly core deposits, have been our primary source of funding and have enabled us to meet successfully both our short-term and long-term liquidity needs. We anticipate that such deposits will continue to be our primary source of funding in the future. Our loan-to-deposit ratio was 74.51% and 70.92% on December 31, 2012 and 2011, respectively.

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The maturity distribution of our time deposits of \$100,000 or more at December 31, 2012, is set forth in the following table:

	December 31, 2012
Three months or less	\$ 17,526,902
Over three through twelve months	38,161,935
Over one year through three years	27,609,916
Over three years	405,093
Total	\$ 83,703,846

Approximately 66.53% of our time deposits of \$100,000 or more had scheduled maturities within one year. Large certificate of deposit customers tend to be extremely sensitive to interest rate levels, making these deposits less reliable sources of funding for liquidity planning purposes than core deposits. We expect most certificates of deposits with maturities less than one year to be renewed upon maturity. However, there is the possibility that some certificates may not be renewed. We believe that, should that occur, the impact would be minimal on our operations and liquidity due to the availability of other funding sources.

**Other Borrowings** - Other borrowings at December 31, 2012 and 2011, consist of the following:

	December 31,	
	2012	2011
Securities sold under agreements to repurchase	\$4,377,978	\$-
Advances from Federal Home Loan Bank	11,000,000	13,000,000
Junior subordinated debentures	10,310,000	10,310,000

Securities sold under agreements to repurchase mature on a one to seven day basis. These agreements are secured by U.S. government agency securities. Advances from the Federal Home Loan Bank mature at different periods, as discussed in the footnotes to the financial statements, and are secured by our one to four family residential mortgage loans and our investment in the Federal Home Loan Bank stock. The junior subordinated debentures mature on November 23, 2035 and have an interest rate of LIBOR plus 1.83%.

## Capital

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Currently, the Bank MOU requires that the Bank maintain a Tier 1 leverage ratio of 8%, and our other regulatory capital ratios at such levels so as to be considered well capitalized for regulatory purposes. We continue to be in full compliance with this requirement of the Bank MOU. Additional discussion of the Bank MOU is included above as part of "Management's Discussion and Analysis of Financial Condition and Results of Operation – Regulatory Matters."

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum ratios of Tier 1 and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk weights ranging from 0% to 100%. Tier 1 capital of the Company consists of common shareholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets. The Company's Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital. The regulatory minimum requirements are 4% for Tier 1 capital and 8% for total risk-based capital; under the provisions of the Bank MOU will be required to maintain a Tier 1 leverage ratio of 8% and a total risk-based capital ratio of 10%.

The Company and the Bank are also required to maintain capital at a minimum level based on quarterly average assets, which is known as the leverage ratio. Only the strongest banks are allowed to maintain capital at the minimum requirement of 3%. All others are subject to maintaining ratios 1% to 2% above the minimum.

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The Company and the Bank were each considered to be “well capitalized” for regulatory purposes at December 31, 2012. The following table shows the regulatory capital ratios for the Company and the Bank at December 31, 2012.

### Analysis of Capital and Capital Ratios

<i>(Dollars in thousands)</i>	Holding	
	Company	Bank
Tier 1 capital	\$50,030	\$45,383
Tier 2 capital	3,933	3,924
Total qualifying capital	\$53,963	\$49,307
Risk-adjusted total assets (including off-balance sheet exposures)	\$314,426	\$313,687
Risk-based capital ratios:		
Total risk-based capital ratio	17.16 %	15.72 %
Tier 1 risk-based capital ratio	15.91	14.47
Tier 1 leverage ratio	11.48	10.40

### Impact of Off-Balance Sheet Instruments

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments consist of commitments to extend credit and standby letters of credit. Commitments to extend credit are legally binding agreements to lend to a customer at predetermined interest rates as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. The exposure to credit loss in the event of nonperformance by the other party to the instrument is represented by the contractual notional amount of the instrument. Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Letters of credit are conditional commitments issued to guarantee a customer’s performance to a third party and have essentially the same credit risk as other lending facilities. Standby letters of credit often expire without being used.

We use the same credit underwriting procedures for commitments to extend credit and standby letters of credit as it does for its on-balance sheet instruments. The creditworthiness of each borrower is evaluated and the amount of collateral, if deemed necessary, is based on the credit evaluation. Collateral held for commitments to extend credit and standby letters of credit varies but may include accounts receivable, inventory, property, plant, equipment, and income-producing commercial properties.



We have not entered into off-balance sheet contractual relationships, other than those disclosed in this report, that could result in liquidity needs or other commitments or that could significantly impact earnings.

At December 31, 2012 we had issued commitments to extend credit of \$28,919,003 and standby letters of credit of \$8,000 through various types of commercial lending arrangements. These commitments included \$26,033,678 of credits with variable interest rates.

The following table sets forth the length of time until maturity for unused commitments to extend credit and standby letters of credit at December 31, 2012.

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<i>(Dollars in Thousands)</i>			<b>After</b>		Greater Than One Year	Total
	Within One Month	After One Through Three Months	Through Twelve Months	Within One Year		
Unused commitments to extend credit	\$ 1,821	\$ 2,029	\$ 11,010	\$ 14,860	\$ 14,059	\$ 28,919
Standby letters of credit	8	-	-	8	-	8
Totals	\$ 1,829	\$ 2,029	\$ 11,010	\$ 14,868	\$ 14,059	\$ 28,927

We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon the extension of credit, is based on its credit evaluation of the borrower. Collateral varies but may include accounts receivable, inventory, premises, furniture and equipment, and commercial and residential real estate.

### **Liquidity Management and Capital Resources**

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and use of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of securities in our investment portfolio is fairly predictable and is subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At December 31, 2012, our liquid assets, consisting of cash and cash equivalents amounted to \$38.1 million, or 9.10% of total assets. Our investment securities, excluding nonmarketable securities, at December 31, 2012, amounted to \$60.1 million, or 14.36% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$14.9 million of these securities were pledged as collateral to secure public deposits and borrowings as of December 31, 2012. At December 31, 2011, our liquid assets, consisting of cash and cash equivalents, amounted to \$44.0 million, or 8.90% of total assets. Our investment securities, excluding nonmarketable securities, at December 31, 2011 amounted to \$84.5 million, or 17.08% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$17.4 million of these securities were pledged as collateral to secure public deposits and borrowings as of December 31, 2011.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. For the near future, it is our intention to reduce the use of wholesale funding to fund loan demand. We plan

to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. At December 31, 2012, we had a \$5.0 million unused line of credit with the Federal Reserve Bank and had sufficient unpledged securities that would have allowed us to borrow an additional \$45.1 million from the Federal Reserve Bank. Also, as a member of the Federal Home Loan Bank of Atlanta, (the "FHLB") we can make applications for borrowings that can be made for leverage purposes. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the bank be pledged to secure any advances from the FHLB. We have an available line to borrow funds from the Federal Home Loan Bank up to 30% of the Bank's total assets, which provide available funds of \$131.7 million at December 31, 2012. At that date the Bank had drawn \$11.0 million on this line. We believe that the sources described above will be sufficient to meet our future liquidity needs.

The Company is largely dependent upon dividends from the Bank as a source of cash. The Bank MOU restricts the ability of the Bank to declare and pay dividends to the Company. The Company MOU requires the Company to obtain approval of the Federal Reserve Bank prior to declaring dividends. The Federal Reserve did not approve the Company's request to pay dividends and interest payments relating to its outstanding classes of preferred stock and trust preferred securities due and payable in the five quarters ended December 31, 2012, nor did Federal Reserve approve the Company's request to make the payments due in the first quarter of 2013. See "Management's Discussion and Analysis of Financial Condition and Results of Operation—Regulatory Matters" for additional information relating to the Company MOU.

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 both 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 board-approved limits.

### Contractual Obligations

The following table provides payments due by period for various contractual obligations as of December 31, 2012:

	Within One Year	After One Two Years	<b>After</b>		After Five Years	Total
			Two Three Years	Three Five Years		
<i>(Dollars in Thousands)</i>						
Certificate accounts <sup>(1)</sup>	\$105,683	\$25,832	\$11,775	\$1,401	\$-	\$144,691
Securities sold under agreements to repurchase <sup>(2)</sup>	4,378	-	-	-	-	4,378
Long-term debt <sup>(3)</sup>	10,000	1,000	-	-	10,310	21,310
Purchases	-	-	-	-	-	-
Operating lease obligations <sup>(4)</sup>	388	351	320	690	4,674	6,423
Totals	\$120,449	\$27,183	\$12,095	\$2,091	\$14,984	\$176,802

<sup>(1)</sup> Certificates of deposit give customers rights to early withdrawal. Early withdrawals may be subject to penalties. The penalty amount depends on the remaining time to maturity at the time of early withdrawal.

<sup>(2)</sup>

We expect securities repurchase agreements to be re-issued and, as such, do not necessarily represent an immediate need for cash.

(3) Long term debt consists of Federal Home Loan Bank borrowings and junior subordinated debentures.

(4) Operating lease obligations include lease obligations for existing and future property and non-cancelable lease commitments for equipment.

During 2012, our primary sources of cash were generated from the net decrease in loans of \$36.2 million, proceeds of \$25.7 million from the sale of securities available-for-sale, \$6.9 million from the sale of other real estate owned and the net increase of \$4.4 million in securities sold under agreements to repurchase. Additionally, we generated \$1.0 million from our operating activities. The primary uses of our cash resources were to reduce time deposits and transactional deposits by \$66.2 million and \$12.3 million, respectively, and to purchase, net of maturities, \$0.2 million of available-for-sale securities. We believe that our overall liquidity sources are adequate to meet our operating needs in the ordinary course of our business.

## **Impact of Inflation**

Unlike most industrial companies, the assets and liabilities of financial institutions such as our bank subsidiary are primarily monetary in nature. Therefore, interest rates have a more significant effect on our performance than do the general rate of inflation and of goods and services. In addition, interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. As discussed previously in "Management Discussion and Analysis - Rate/Volume Analysis," we seek to manage the relationships between interest sensitive-assets and liabilities in order to protect against wide interest rate fluctuations, including those resulting from inflation.

## **Accounting and Financial Reporting Issues**

We have adopted various accounting policies, which govern the application of accounting principles generally accepted in the United States in the preparation of its consolidated financial statements. The significant accounting policies are described in the footnotes to the financial statements at December 31, 2012 as filed in the Annual Report on Form 10-K. Certain accounting policies involve significant judgments and assumptions by management which have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgments and assumptions used are based on historical experience and other factors, which management believes to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made, actual results could differ from these judgments and estimates which could have a material impact on the carrying values of assets and liabilities and the results of operations.

Of these significant accounting policies, the Company considers its policies regarding the allowance for loan losses to be its most critical accounting policy due to the significant degree of management judgment involved in determining the amount of allowance. The Company has developed policies and procedures for assessing the adequacy of the allowance, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Company's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers that is not known to management at the time of the issuance of the consolidated financial statements. Refer to the discussion under "Management's Discussion and Analysis - Provision and Allowance for Loan Losses" for a detailed description of the Company's estimation process and methodology related to the allowance for loan losses.

## **Effect of Governmental Policies**

We are affected by the policies of regulatory authorities, including Federal Reserve Board and the FDIC. An important function of the Federal Reserve Board is to regulate the national money supply. Among the instruments of

monetary policy used by the Federal Reserve Board are: purchase and sale of U.S. Government securities in the market place; changes in the discount rate, which is the rate any depository institution must pay to from the Federal Reserve; and changes in the reserve requirements of depository institutions. These instruments are effective in influencing the economic and monetary growth, interest rate levels and inflation.

The monetary policies of the Federal Reserve Board and other governmental policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. Because of changing conditions in the national and international economy and in the money markets, as well as the result of actions by monetary and fiscal authorities, it is not possible to predict with certainty future changes in interest rates, deposit levels or loan demand or whether the changing economic conditions will have a positive or negative effect on operations and earnings.

Legislation from time to time is introduced into the United States Congress and the South Carolina Legislature and other state legislatures, and regulations are proposed by the regulatory agencies that could affect our business. It cannot be predicted whether or in what form any of these proposals will be adopted or the extent to which our business may be affected thereby.

#### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Pursuant to the revised disclosure requirements for smaller reporting companies effective February 4, 2008, no disclosure under this Item is required.



**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors

First Reliance Bancshares, Inc. and Subsidiary

Florence, South Carolina

We have audited the accompanying consolidated balance sheets of First Reliance Bancshares, Inc. and subsidiary (the "Company") as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income (loss), changes in shareholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Reliance Bancshares, Inc. and subsidiary as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ Elliott Davis, LLC

Columbia, South Carolina  
March 22, 2013



**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

## Consolidated Balance Sheets

	December 31,	
	2012	2011
Assets		
Cash and cash equivalents:		
Cash and due from banks	\$2,893,020	\$2,134,864
Interest-bearing deposits with other banks	35,169,883	41,885,966
Total cash and cash equivalents	38,062,903	44,020,830
Time deposits in other banks	100,953	100,373
Securities available-for-sale	60,071,012	84,534,318
Nonmarketable equity securities	1,297,400	2,431,800
Total investment securities	61,368,412	86,966,118
Mortgage loans held for sale	5,621,860	2,863,297
Loans receivable	260,257,334	303,398,403
Less allowance for loan losses	(4,167,482 )	(7,743,470 )
Loans, net	256,089,852	295,654,933
Premises, furniture and equipment, net	24,626,975	25,205,064
Accrued interest receivable	1,276,898	1,938,807
Other real estate owned	15,289,991	22,135,921
Cash surrender value life insurance	12,599,787	12,228,829
Other assets	3,239,579	3,852,250
Total assets	\$418,277,210	\$494,966,422
Liabilities and Shareholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing transaction accounts	\$58,023,250	\$52,299,017
Interest-bearing transaction accounts	42,568,838	42,092,193
Savings	104,031,114	122,528,570
Time deposits \$100,000 and over	83,703,846	122,474,202
Other time deposits	60,987,086	88,422,515
Total deposits	349,314,134	427,816,497
Securities sold under agreement to repurchase	4,377,978	-
Advances from Federal Home Loan Bank	11,000,000	13,000,000
Junior subordinated debentures	10,310,000	10,310,000

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Accrued interest payable	465,409	317,678
Other liabilities	1,611,762	2,404,257
Total liabilities	377,079,283	453,848,432

**Commitments and contingencies** - Notes 4 and 15

Shareholders' Equity

Preferred stock

Series A cumulative perpetual preferred stock - 15,349 shares issued and outstanding	15,120,344	14,925,265
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Series B cumulative perpetual preferred stock - 767 shares issued and outstanding	786,399	802,951
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Series C cumulative mandatory convertible preferred stock - 2,293 shares issued and outstanding	2,293,000	2,293,000
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Common stock, \$0.01 par value; 20,000,000 shares authorized, 4,094,861 and 4,084,400 shares issued and outstanding at December 31, 2012 and 2011, respectively	40,949	40,844
---	--------	--------

Capital surplus	27,991,132	27,992,485
-----------------	------------	------------

Treasury stock, at cost, 19,289 and 13,245 shares at December 31, 2012 and 2011, respectively	(182,234 )	(173,650 )
---	------------	------------

Nonvested restricted stock	(123,466 )	(320,196 )
----------------------------	------------	------------

Retained deficit	(6,207,116 )	(6,304,429 )
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Accumulated other comprehensive income	1,478,919	1,861,720
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Total shareholders' equity	41,197,927	41,117,990
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Total liabilities and shareholders' equity	\$418,277,210	\$494,966,422
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The accompanying notes are an integral part of the consolidated financial statements.

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY****Consolidated Statements of Operations**

	For the years ended December 31,	
	2012	2011
Interest income:		
Loans, including fees	\$ 16,419,908	\$ 19,895,558
Investment securities:		
Taxable	1,773,843	1,696,628
Tax exempt	506,305	1,491,140
Other interest income	112,479	101,682
Total	18,812,535	23,185,008
Interest expense:		
Time deposits	3,545,095	5,175,743
Other deposits	430,604	1,024,185
Other interest expense	505,617	312,751
Total	4,481,316	6,512,679
Net interest income	14,331,219	16,672,329
Provision for loan losses	1,945,861	5,403,416
Net interest income after provision for loan losses	12,385,358	11,268,913
Noninterest income:		
Service charges on deposit accounts	1,841,685	1,821,695
Gain on sale of mortgage loans	1,197,853	972,173
Income from bank owned life insurance	370,957	400,873
Other service charges, commissions, and fees	975,143	852,684
Gain on sale of available-for-sale securities	1,806,414	516,582
Other	344,137	283,135
Total	6,536,189	4,847,142
Noninterest expenses:		
Salaries and benefits	7,804,091	8,986,480
Occupancy	1,463,448	1,480,073
Furniture and equipment related expenses	1,495,911	1,204,178
Other	7,875,506	8,691,734
Total	18,638,956	20,362,465
Income (loss) before income taxes	282,591	(4,246,410 )

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Income tax expense	6,751	5,134,705
Net income (loss)	275,840	(9,381,115 )
Preferred stock dividends accrued	996,990	996,990
Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium	178,527	178,040
Net loss available to common shareholders	\$(899,677 )	\$(10,556,145)
Average common shares outstanding, basic	4,093,892	4,100,972
Average common shares outstanding, diluted	4,093,892	4,100,972
Loss per common share:		
Basic	\$(0.22 )	\$(2.57 )
Diluted	(0.22 )	(2.57 )

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

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

## Consolidated Statements of Comprehensive Income (Loss)

	For the years ended	
	December 31,	
	2012	2011
Net income (loss) from operations	\$275,840	\$(9,381,115)
Other Comprehensive income, net of tax:		
Unrealized holding gains on available-for-sale securities arising during the year	1,226,412	4,176,295
Income tax expense	416,980	1,386,705
Net of income taxes	809,432	2,789,590
Reclassification adjustment for gains (loss) realized in net income from operations	1,806,414	516,582
Income tax expense	614,181	175,638
Net of income taxes	(1,192,233)	(340,944 )
Other comprehensive income (loss)	(382,801 )	2,448,646
Comprehensive loss	\$(106,961 )	\$(6,932,469)

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

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY****Consolidated Statements of Shareholders' Equity****For the years ended December 31, 2012 and 2011**

	Preferred Stock	Common Stock	Capital Surplus	Treasury Stock	Nonvested Restricted Stock	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2010	\$17,843,176	\$41,159	\$28,140,094	\$(168,864)	\$(679,264)	\$4,002,469	\$(586,926 )	\$48,591,844
Net loss						(9,381,115)		(9,381,115 )
Other comprehensive income, net of tax expense of \$1,211,067							2,448,646	2,448,646
Preferred Stock Dividend paid						(747,743 )		(747,743 )
Accretion of Series A Preferred stock discount	194,545					(194,545 )		-
Amortization of Series B Preferred stock premium	(16,505 )					16,505		-
Issuance Common Stock		9	2,361					2,370
Net Change in Restricted Stock		(324 )	(149,970 )		359,068			208,774
				(4,786 )				(4,786 )



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Purchase of  
treasury stock

Balance,  
December 31, 2011 \$18,021,216 \$40,844 \$27,992,485 \$(173,650) \$(320,196) \$(6,304,429) \$1,861,720 \$41,117,990

Net income 275,840 275,840

Other  
comprehensive  
loss, net of tax  
benefit of  
\$197,200 (382,801 ) (382,801 )

Accretion of  
Series A  
Preferred stock  
discount 195,078 (195,078 ) -

Amortization  
of Series B  
Preferred stock  
premium (16,551 ) 16,551 -

Issuance  
Common Stock 30 4,975 5,005

Net Change in  
Restricted  
Stock 75 (6,328 ) 196,730 190,477

Purchase of  
treasury stock (8,584 ) (8,584 )

Balance,  
December 31, 2012 \$18,199,743 \$40,949 \$27,991,132 \$(182,234) \$(123,466) \$(6,207,116) \$1,478,919 \$41,197,927

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

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY****Consolidated Statements of Cash Flows**

	For the years ended December 31,	
	2012	2011
Cash flows from operating activities:		
Net income (loss)	\$275,840	\$(9,381,115 )
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	1,945,861	5,403,416
Depreciation and amortization expense	947,484	976,849
Gain on sales of securities available-for-sale	(1,806,414 )	(516,582 )
Loss on sale of other real estate owned	162,001	57,818
Loss on sale of premises, furniture and equipment	4,323	-
Discount accretion and premium amortization	233,425	203,409
Disbursements for mortgages held for sale	(44,272,023)	(40,110,158)
Proceeds from sales of mortgages held for sale	41,513,460	38,448,697
Net decrease in valuation allowance for loans held-for-sale	-	(16,260 )
Write down of other real estate owned	1,191,087	1,104,255
Deferred income tax expense	-	5,130,390
Decrease in interest receivable	661,909	478,327
Increase (decrease) in interest payable	147,731	(229,544 )
Increase for cash surrender value of life insurance	(370,958 )	(400,872 )
Amortization of deferred compensation on restricted stock	190,477	208,774
Decrease in other assets	682,504	1,109,648
Increase (decrease) in other liabilities	(792,495 )	485,385
Net cash provided by operating activities	714,212	2,952,437
Cash flows from investing activities:		
Purchases of securities available-for-sale	(13,220,603)	(44,587,975)
Maturities of securities available-for-sale	12,999,113	7,691,841
Proceeds from sale of securities available-for-sale	25,677,783	40,807,256
Redemption of nonmarketable equity securities	1,134,400	1,925,500
Net increase in time deposits in other banks	(580 )	(373 )
Net decrease in loans receivable	31,022,460	32,949,398
Proceeds from sale of premises, furniture and equipment	64,500	-
Purchases of premises, furniture and equipment	(310,850 )	(147,132 )
Improvements to other real estate owned	-	(6,987 )
Proceeds from sale of other real estate owned	12,089,602	5,427,221
Net cash provided by investing activities	69,455,825	44,058,749
Cash flows from financing activities:		
	(12,296,578)	25,100,919

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Net increase (decrease) in demand deposits, interest-bearing transaction accounts and savings accounts		
Net decrease in certificates of deposit and other time deposits	(66,205,785)	(52,534,887)
Decreases in advances from Federal Home Loan Bank	(2,000,000 )	-
Net increase (decrease) in securities sold under agreements to repurchase	4,377,978	(476,522 )
Preferred stock dividends paid	-	(747,743 )
Net proceeds from issuance of common stock	5,005	2,370
Purchase of treasury stock	(8,584 )	(4,786 )
Net cash used by financing activities	(76,127,964)	(28,660,649)
Net increase (decrease) in cash and cash equivalents	(5,957,927 )	18,350,537
Cash and cash equivalents, beginning of year	44,020,830	25,670,293
Cash and cash equivalents, end of year	\$38,062,903	\$44,020,830
Cash paid during the year for:		
Income taxes	\$-	\$8,000
Interest	\$4,333,585	\$6,742,223
Supplemental noncash investing and financing activities:		
Foreclosures on loans	\$6,596,760	\$14,049,177
Net change in valuation allowance for available-for-sale securities	\$(382,801 )	\$2,448,646

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

## Notes to Consolidated Financial Statements

### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Organization** - First Reliance Bancshares, Inc. (the "Company") was incorporated to serve as a bank holding company for its subsidiary, First Reliance Bank (the "Bank"). First Reliance Bank was incorporated on August 9, 1999 and commenced business on August 16, 1999. The principal business activity of the Bank is to provide banking services to domestic markets, principally in Florence, Lexington, and Charleston Counties in South Carolina. The Bank is a state-chartered commercial bank, and its deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"). The consolidated financial statements include the accounts of the parent company and its wholly-owned subsidiary after elimination of all significant intercompany balances and transactions. In 2005, the Company formed First Reliance Capital Trust I (the "Trust") for the purpose of issuing trust preferred securities. In accordance with current accounting guidance, the Trust is not consolidated in these financial statements.

**Management's Estimates** - The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans, including valuation allowances for impaired loans, and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowances for losses on loans and valuation of foreclosed real estate, management obtains independent appraisals in accordance with regulatory policy. Management must also make estimates in determining the estimated useful lives and methods for depreciating premises and equipment.

While management uses available information to recognize losses on loans and foreclosed real estate, future additions to the allowances may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowances for losses on loans and foreclosed real estate. Such agencies may require the Company to recognize additions to the allowances based on their judgments about information available to them at the time of their examinations. Because of these factors, it is reasonably possible that the allowances for losses on loans and foreclosed real estate may change materially in the near term.

**Concentrations of Credit Risk** - Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of loans receivable, investment securities, federal funds sold and amounts due from banks.

The Company makes loans to individuals and small businesses for various personal and commercial purposes primarily in Florence, Lexington, Charleston and Mount Pleasant, South Carolina. At December 31, 2012, the majority of the total loan portfolio was to borrowers from within these areas.

The Company's loan portfolio is not concentrated in loans to any single borrower or a relatively small number of borrowers. Additionally, management is not aware of any concentrations of loans to groups of borrowers or industries that would also be affected by sector-specific economic conditions.

In addition to monitoring potential concentrations of loans to particular borrowers or groups of borrowers, industries and geographic regions, management monitors exposure to credit risk from concentrations of lending products and practices such as loans that subject borrowers to substantial payment increases (e.g., principal deferral periods, loans with initial interest-only periods, etc.), and loans with high loan-to-value ratios. Management has determined that there is minimal concentration of credit risk associated with its lending policies or practices.

Additionally, there are industry practices that could subject the Company to increased credit risk should economic conditions change over the course of a loan's life. For example, the Company makes variable rate loans and fixed rate principal-amortizing loans with maturities prior to the loan being fully paid (i.e., balloon payment loans). These loans are underwritten and monitored to manage the associated risks. Therefore, management believes that these particular practices do not subject the Company to unusual credit risk. The Company's investment portfolio consists principally of obligations of the United States and its agencies or its corporations and obligations of state and local governments. In the opinion of management, there is no concentration of credit risk in its investment portfolio. The Company places its deposits and correspondent accounts with and sells its federal funds to high quality institutions. Management believes credit risk associated with correspondent accounts is not significant.

**Securities Available-for-Sale** - Securities available-for-sale are carried at amortized cost and adjusted to estimated market value by recognizing the aggregate unrealized gains or losses in a valuation account. Aggregate market valuation adjustments are recorded as part of the comprehensive income in shareholders' equity net of deferred income taxes. Reductions in market value considered by management to be other than temporary are reported as a realized loss and a reduction in the cost basis of the security. The adjusted cost basis of investments available-for-sale is determined by specific identification and is used in computing the gain or loss upon sale.

**Nonmarketable Equity Securities** - At December 31, 2012 and 2011, non-marketable equity securities consist of the following:

	December 31,	
	2012	2011
Federal Home Loan Bank stock	\$1,239,300	\$2,373,700
Community Bankers Bank stock	58,100	58,100
Total	\$1,297,400	\$2,431,800

Nonmarketable equity securities are carried at cost since no quoted market value and no ready market exists. Investment in the Federal Home Loan Bank is a condition of borrowing from the Federal Home Loan Bank, and the stock is pledged to collateralize such borrowings. Dividends received on nonmarketable equity securities are included as a separate component of interest income.

**Mortgage Loans Held For Sale** - The Company's mortgage activities are comprised of accepting residential mortgage loan applications, qualifying borrowers to standards established by investors, funding residential mortgages and selling mortgages to investors under pre-existing commitments on a best efforts basis. Funded residential mortgages held temporarily for sale to investors are recorded at the lower of cost or market value. Gains or losses are recognized when control over these assets has been surrendered and are included in gain on sale of mortgage loans in the consolidated statements of income.

**Loans Receivable** - Loans receivable are stated at their unpaid principal balance. Interest income is computed using the simple interest method and is recorded in the period earned.

When serious doubt exists as to the collectibility of a loan or when a loan becomes contractually ninety days past due as to principal or interest, interest income is generally discontinued unless the estimated net realizable value of collateral exceeds the principal balance and accrued interest. When interest accruals are discontinued, income earned but not collected is reversed.

Loan origination and commitment fees and certain direct loan origination costs (principally, salaries and employee benefits) are deferred and amortized to income over the contractual life of the related loans or commitments, adjusted for prepayments, using the straight-line method.

**Allowance for Loan Losses** - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when

management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows or collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement.

Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

In situations where, for economic or legal reasons related to a borrower's financial difficulties, a concession to the borrower is granted that the Company would not otherwise consider, the related loan is classified as a troubled debt restructuring. The restructuring of a loan may include the transfer from the borrower to the Company of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan, modification of the loan terms, or a combination of the above.

**Premises, Furniture and Equipment** - Premises, furniture and equipment are stated at cost, less accumulated depreciation. The provision for depreciation is computed by the straight-line method, based on the estimated useful lives for buildings of 40 years and for furniture and equipment of 5 to 10 years. Leasehold improvements are being amortized over 20 years. The cost of assets sold or otherwise disposed of and the related allowance for depreciation is eliminated from the accounts and the resulting gains or losses are reflected in the income statement when incurred. Maintenance and repairs are charged to current expense. The costs of major renewals and improvements are capitalized based upon the Company's policy.

**Other Real Estate Owned** - Other real estate owned includes real estate acquired through foreclosure. Other real estate owned is carried at the lower of cost or the fair market value minus estimated costs to sell. Any write-downs at the date of foreclosure are charged to the allowance for loan losses. Expenses to maintain such assets and subsequent changes in the valuation allowance are included in other noninterest expense along with gains and losses on disposal.

**Cash Surrender Value of Life Insurance** - Cash surrender value of life insurance represents the cash value of policies on certain current and former officers of the Company.

**Residential Mortgage Origination Fees** - Residential mortgage origination fees include fees from residential mortgage loans originated by the Company and subsequently sold in the secondary market. These fees are recognized as income at the time of the sale to the investor.

**Income Taxes** - Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. In addition,



deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Interest and penalties related to income tax matters is recognized in income tax expense. The Company recorded a partial valuation allowance of \$172,548 and \$7,286,724 in 2012 and 2011, respectively.

**Advertising Expense** - Advertising and public relations costs are generally expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expensed in the period in which the direct mailings are sent. Advertising and public relations costs of \$151,298 and \$239,952 were included in the Company's results of operations for 2012 and 2011, respectively.

**Retirement Benefits** - A trustee retirement savings plan is sponsored by the Company and provides retirement benefits to substantially all officers and employees who meet certain age and service requirements. The plan includes a "salary reduction" feature pursuant to Section 401(k) of the Internal Revenue Code. In 2004, the Company converted the 401(k) plan to a 404(c) plan. The 404(c) plan changes investment alternatives to include the Company's stock. Under the plan and present policies, participants are permitted to make contributions up to 15% of their annual compensation. At its discretion, the Company can make matching contributions up to 6% of the participants' compensation. The Company charged \$114,697 and \$130,533 to earnings for the retirement savings plan in 2012 and 2011, respectively.

During 2006, the Board of Directors approved a supplemental retirement plan for the directors and certain officers. These benefits are not qualified under the Internal Revenue Code and they are not funded. For 2012 and 2011 the supplemental retirement expense was \$203,152 and \$148,261, respectively. The current accrued but unfunded amount is \$1,135,078 and \$955,265 at December 31, 2012 and 2011, respectively. However, certain funding is provided informally and indirectly by bank owned life insurance policies. The cash surrender value of the life insurance policies is recorded as a separate line item in the accompanying consolidated balances sheets at \$12,599,787 and \$12,228,829 at December 31, 2012 and 2011, respectively.

The Company has split-dollar life insurance arrangements with certain of its officers. At December 31, 2012 and 2011, the split-dollar liability relating to these arrangements totaled \$238,510 and \$245,220, respectively. For 2012, the Company recognized net income of \$6,710 related to these arrangements. There was no income or expense related to these arrangements for 2011.

**Equity Incentive Plan** - On January 19, 2006, the Company approved the 2006 Equity Incentive Plan. This plan provides for the granting of dividend equivalent rights, options, performance unit awards, phantom shares, stock appreciation rights and stock awards, each of which shall be subject to such conditions based upon continued employment, passage of time or satisfaction of performance criteria or other criteria as permitted by the plan. The plan allows granting up to 950,000 shares of stock to officers, employees, and directors, consultants and service providers of the Company or its affiliates. Awards may be granted for a term of up to ten years from the effective date of grant. Under this Plan, our Board of Directors has sole discretion as to the exercise date of any awards granted. The per-share exercise price of incentive stock options may not be less than the market value of a share of common stock on the date the option is granted. The related compensation cost for all stock-based awards is recognized over the service period for awards expected to vest. Any options that expire unexercised or are canceled become available for re-issuance. The Company's equity incentive plan is further described in Note 16.

**Common Stock Owned by the 401(k) Plan and Employee Stock Ownership Plan (ESOP)** - All shares held by the 401(k) and ESOP Plans, collectively referred to as the "404(c)," are treated as outstanding for purposes of computing earnings per share. 404(c) purchases and redemptions of the Company's common stock are at estimated fair value as determined by independent valuations. Dividends on 404(c) shares are charged to retained earnings. At December 31, 2012, the 404(c) owned 281,641 shares of the Company's common stock with an estimated value of \$468,096. At December 31, 2011, the 404(c) owned 236,443 shares of the Company's common stock with an estimated value of \$447,598. All of these shares were allocated. Contributions to the 404(c) in 2012 and 2011 were \$114,697 and \$130,533, respectively.

**Loss Per Common Share** - Basic earnings (loss) per common share represents income (loss) available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and similar share-based compensation instruments and are determined using the treasury stock method (see Note 17). Due to operating losses, common stock equivalents are antidilutive and therefore basic and diluted loss per share are equal.

**Derivative Instruments** - The Company has no material embedded derivative instruments requiring separate accounting treatment. The Company has freestanding derivative instruments consisting of fixed rate conforming loan commitments and commitments to sell fixed rate conforming loans. The Company does not currently engage in hedging activities.

**Statements of Cash Flows** - For purposes of reporting cash flows in the consolidated financial statements, the Company considers certain highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents include amounts due from banks and federal funds sold. Generally, federal funds are sold for one-day periods. Changes in the valuation account of securities available-for-sale, including the deferred tax effects, are considered noncash transactions for purposes of the statement of cash flows and are presented in detail in the notes to the consolidated financial statements.

**Off-Balance Sheet Financial Instruments** - In the ordinary course of business, the Company enters into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. These financial instruments are recorded in the consolidated financial statements when they become payable by the customer.

**Recently Issued Accounting Pronouncements** - The following is a summary of recent authoritative pronouncements:

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the Accounting Standards Codification (“ASC”) was amended by Accounting Standards Update (“ASU”) 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments were effective for the Company on January 1, 2012 and had no effect on the financial statements.

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments were effective for the Company beginning January 1, 2012 and had no effect on the financial statements.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and requires consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company on January 1, 2012 and have been applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements. Companies should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the amendments while the Financial Accounting Standards Board ("FASB") redeliberates future requirements.

The FASB amended the Comprehensive Income topic of the ASC in February 2013. The amendment addresses reporting of amounts reclassified out of accumulated other comprehensive income. Specifically, the amendment does not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendment does require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, in certain circumstances an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income. The amendment will be effective for the Company on a prospective basis for reporting periods beginning after December 15, 2012. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

**Risks and Uncertainties** - In the normal course of its business, the Company encounters two significant types of risks: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different basis, than its interest-earning assets. Credit risk is the risk of default on the Company's loan portfolio that results from borrower's inability or unwillingness to make contractually required payments. Market risk reflects changes in the value of collateral underlying loans receivable and the valuation of real estate held by the Company.

The Company is subject to the regulations of various governmental agencies (regulatory risk). These regulations can and do change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies, which may subject it to further changes with respect to asset valuations, amounts of required loss allowances and operating restrictions from the regulators' judgments based on information available to them at the time of their examination.

**Reclassifications** - Certain captions and amounts in the 2011 consolidated financial statements were reclassified to conform with the 2012 presentation. The reclassifications did not have an impact on net loss or shareholders' equity.

**NOTE 2 - CASH AND DUE FROM BANKS**

The Company is required to maintain balances with the Federal Reserve computed as a percentage of deposits. At December 31, 2012 and 2011, this requirement was \$1,611,000 and \$0, respectively, net of vault cash and balances on deposit with the Federal Reserve.

**NOTE 3 - INVESTMENT SECURITIES**

The amortized cost and estimated fair values of securities available-for-sale were:

	Amortized Cost	Gross Unrealized Gains	Losses	Estimated Fair Value
December 31, 2012				
U.S. Government sponsored agencies	\$7,591,892	\$517,136	\$-	\$8,109,028
Mortgage-backed securities	50,197,908	1,758,576	-	51,956,484
Equity security	100,000	-	94,500	5,500
Total	\$57,889,800	\$2,275,712	\$94,500	\$60,071,012

	Amortized Cost	Gross Unrealized Gains	Losses	Estimated Fair Value
December 31, 2011				
U.S. Government sponsored agencies	\$2,839,706	\$185,239	\$-	\$3,024,945
Mortgage-backed securities	59,748,500	1,816,651	4,749	61,560,402
Municipals	19,084,899	853,072	-	19,937,971
Equity security	100,000	-	89,000	11,000
Total	\$81,773,105	\$2,854,962	\$93,749	\$84,534,318

The following is a summary of maturities of securities available-for-sale as of December 31, 2012. The amortized cost and estimated fair values are based on the contractual maturity dates. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalty. Mortgage-backed securities are presented as a separate line, maturities of which are based on expected maturities since paydowns are expected to occur before contractual maturity dates.

	Amortized Cost	Estimated Fair Value
U.S. Government sponsored agencies - due after ten years	\$7,591,892	\$8,109,028
Mortgage-backed securities	50,197,908	51,956,484
Equity security	100,000	5,500
Total	\$57,889,800	\$60,071,012

The following table shows gross unrealized losses and fair value, aggregated by investment category, and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2012 and 2011.

	December 31, 2012		December 31, 2011	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Less Than 12 Months				
U.S. Government sponsored agencies	\$-	\$-	\$5,085,963	\$4,749
12 Months or More				
Equity security	5,500	94,500	11,000	89,000
Total securities available-for-sale	\$5,500	\$94,500	\$5,096,963	\$93,749

At December 31, 2012, securities classified as available-for-sale were recorded at fair market value. The entire amount of the unrealized losses is the result of a single security in a continuous loss position for twelve months or more. The Company does not intend to sell this security in the near future and it is more likely than not that the Company will not be required to sell this security before recovery of its amortized cost. The Company believes, based on industry analyst reports and credit ratings, that the deterioration in value is not considered other-than-temporary.

During 2012 and 2011, gross proceeds from the sale of available-for-sale securities were \$25,677,783 and \$40,807,256, respectively. Gross gains on sales of available-for-sale securities totaled \$1,806,414 and \$516,582 for 2012 and 2011, respectively. There were no gross losses on sales of available-for-sale securities during 2012 and 2011.

At December 31, 2012 and 2011, investment securities with a par value of \$14,110,930 and \$16,392,173 and a fair market value of \$14,929,175 and \$17,368,901, respectively, were pledged as collateral to secure public deposits and borrowings.

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**NOTE 4 – LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES**

Major classifications of loans receivable are summarized as follows:

	December 31,	
	2012	2011
Real estate loans:		
Construction	\$31,985,532	\$43,320,482
Residential:		
Residential 1-4 family	35,091,846	42,837,510
Multifamily	5,563,043	8,630,232
Second mortgages	4,077,692	4,503,752
Equity lines of credit	22,502,339	24,998,277
Total residential	67,234,920	80,969,771
Nonresidential	122,309,917	133,603,482
Total real estate loans	221,530,369	257,893,735
Commercial and industrial	29,255,564	36,465,095
Consumer	9,304,913	8,649,649
Other	166,488	389,924
Total loans	\$260,257,334	\$303,398,403

The Company has pledged certain loans as collateral to secure its borrowings from the Federal Home Loan Bank. The total of loans pledged was \$54,941,097 and \$35,976,783 at December 31, 2012 and 2011, respectively.

Loans sold with limited recourse are 1-4 family residential mortgages originated by the Company and sold to various other financial institutions. These loans are sold with the agreement that a loan may be returned to the Company within 90 days of purchase, at any time in the event the Company fails to provide necessary documents related to the mortgages to the buyers, or if the Company makes false representations or warranties to the buyers. Loans sold under these agreements in 2012 totaled \$41,513,460. The Company uses the same credit policies in making loans held for sale as it does for on-balance-sheet instruments.

The following is an analysis of the allowance for loan losses by class of loans for the years ended December 31, 2012 and 2011.

**December 31, 2012**

Total



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(Dollars in Thousands)	Real Estate Loans				Real Estate Loans	Commercial	Consumer and Other
	Total	Construction	Residential	Non-Residential			
Beginning balance	\$7,743	\$3,291	\$ 2,757	\$ 1,081	\$7,129	\$ 575	\$ 39
Provisions	1,946	148	(850 )	1,819	1,117	819	10
Recoveries	1,104	298	129	54	481	613	10
Charge-offs	(6,626)	(2,296)	(1,085 )	(1,825 )	(5,206)	(1,391 )	(29 )
Ending balance	\$4,167	\$1,441	\$ 951	\$ 1,129	\$3,521	\$ 616	\$ 30

**December 31, 2011**

(Dollars in Thousands)	Real Estate Loans				Total Real Estate Loans	Commercial	Consumer and Other
	Total	Construction	Residential	Non-Residential			
Beginning balance	\$6,271	\$2,548	\$ 1,730	\$ 947	\$5,225	\$ 998	\$ 48
Provisions	5,403	2,212	2,580	602	5,394	(9 )	18
Recoveries	639	356	88	70	514	113	12
Charge-offs	(4,570)	(1,825)	(1,641 )	(538 )	(4,004)	(527 )	(39 )
Ending balance	\$7,743	\$3,291	\$ 2,757	\$ 1,081	\$7,129	\$ 575	\$ 39

The following is a summary of loans evaluated for impairment individually and collectively, by class, for the years ended December 31, 2012 and 2011.

**December 31, 2012**

(Dollars in Thousands)	Real Estate Loans				Total Real Estate Loans	Commercial	Consumer and Other
	Total	Construction	Residential	Non- Residential			
Allowance Evaluated for impairment							
Individually	\$524	\$23	\$ 106	\$ 362	\$491	\$ 20	\$ 13
Collectively	3,643	1,418	845	767	3,030	596	17
Allowance for loan losses	\$4,167	\$1,441	\$ 951	\$ 1,129	\$3,521	\$ 616	\$ 30
Total Loans Evaluated for impairment							
Individually	\$28,030	\$6,151	\$ 5,323	\$ 14,464	\$25,938	\$ 1,973	\$ 119
Collectively	232,227	25,834	61,912	107,846	195,592	27,283	9,352
Loans receivable	\$260,257	\$31,985	\$ 67,235	\$ 122,310	\$221,530	\$ 29,256	\$ 9,471

**December 31, 2011**

(Dollars in Thousands)	Real Estate Loans				Total Real Estate Loans	Commercial	Consumer and Other
	Total	Construction	Residential	Non- Residential			
Allowance Evaluated for impairment							
Individually	\$2,665	\$1,782	\$ 344	\$ 471	\$2,597	\$ 55	\$ 13
Collectively	5,078	1,509	2,413	610	4,532	520	26
Allowance for loan losses	\$7,743	\$3,291	\$ 2,757	\$ 1,081	\$7,129	\$ 575	\$ 39
Total Loans Evaluated for impairment							
Individually	\$26,503	\$8,618	\$ 4,644	\$ 11,895	\$25,157	\$ 1,299	\$ 47
Collectively	276,895	34,702	76,326	121,708	232,736	35,166	8,993
Loans receivable	\$303,398	\$43,320	\$ 80,970	\$ 133,603	\$257,893	\$ 36,465	\$ 9,040

The Company identifies impaired loans through its normal internal loan review process. Loans on the Company's problem loan watch list are considered potentially impaired loans. These loans are evaluated in determining whether all outstanding principal and interest are expected to be collected. Loans are not considered impaired if a minimal delay occurs and all amounts due including accrued interest at the contractual interest rate for the period of delay are expected to be collected.

The following summarizes the Company's impaired loans as of December 31, 2012.

(Dollars in Thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment
With no related allowance recorded:				
Real estate				
Construction	\$ 3,157	\$ 3,827	\$ -	\$ 3,755
Residential	3,825	4,209	-	4,138
Nonresidential	10,311	11,439	-	9,941
Total real estate loans	17,293	19,475	-	17,834
Commercial	1,953	1,990	-	1,334
Consumer and other	80	81	-	42
	19,326	21,546	-	19,210

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(Dollars in Thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment
With an allowance recorded:				
Real estate				
Construction	2,994	3,102	23	3,099
Residential	1,498	1,500	106	1,410
Nonresidential	4,153	4,744	362	3,183
Total real estate loans	8,645	9,346	491	7,692
Commercial	20	20	20	603
Consumer and other	39	39	13	27
	8,704	9,405	524	8,322
Total				
Real estate				
Construction	6,151	6,929	23	6,854
Residential	5,323	5,709	106	5,548
Nonresidential	14,464	16,183	362	13,124
Total real estate loans	25,938	28,821	491	25,526
Commercial	1,973	2,010	20	1,937
Consumer and other	119	120	13	69
Total	\$ 28,030	\$ 30,951	\$ 524	\$ 27,532

The following summarizes the Company's impaired loans as of December 31, 2011.

(Dollars in Thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment
With no related allowance recorded:				
Real estate				
Construction	\$ 3,308	\$ 3,372	\$ -	\$ 6,914
Residential	3,266	3,266	-	3,170
Nonresidential	10,276	10,642	-	6,892
Total real estate loans	16,580	17,280	-	16,976
Commercial	1,072	1,202	-	919
Consumer and other	24	24	-	23
	17,946	18,506	-	17,918
With an allowance recorded:				
Real estate				
Construction	5,310	6,370	1,782	6,039
Residential	1,378	1,659	344	705
Nonresidential	1,619	1,715	471	744
Total real estate loans	8,307	9,744	2,597	7,488
Commercial	227	227	55	178
Consumer and other	23	23	13	5
	8,557	9,994	2,665	7,671

Total				
Real estate				
Construction	8,618	9,742	1,782	12,953
Residential	4,644	4,925	344	3,875
Nonresidential	11,895	12,357	471	7,636
Total real estate loans	25,157	27,024	2,597	24,464
Commercial	1,299	1,429	55	1,097
Consumer and other	47	47	13	28
Total	\$ 26,503	\$ 28,500	\$ 2,665	\$ 25,589

Interest income on impaired loans, other than nonaccrual loans, is recognized on an accrual basis. Interest income on nonaccrual loans is recognized only as collected. During 2012 and 2011 interest income recognized on nonaccrual loans was \$677,458 and \$467,797, respectively. If the nonaccrual loans had been accruing interest at their original contracted rates, interest income related to these nonaccrual loans would have been \$1,234,852 and \$984,248 for 2012 and 2011, respectively.

A summary of current, past due and nonaccrual loans as of December 31, 2012 was as follows:

<i>(Dollars in Thousands)</i>	Past Due	Past Due Over 90 Days		Total Past Due	Current	Total Loans
	30-89 Days	and Accruing	Non- Accruing			
Real estate						
Construction	\$ 62	\$ -	\$ 2,874	\$ 2,936	\$ 29,049	\$ 31,985
Residential	1,340	-	3,779	5,119	62,116	67,235
Nonresidential	566	-	12,354	12,920	109,390	122,310
Total real estate loans	1,968	-	19,007	20,975	200,555	221,530
Commercial	37	-	1,879	1,916	27,340	29,256
Consumer and other	22	6	88	116	9,355	9,471
Totals	\$ 2,027	\$ 6	\$ 20,974	\$ 23,007	\$ 237,250	\$ 260,257

A summary of current, past due and nonaccrual loans as of December 31, 2011 was as follows:

<i>(Dollars in Thousands)</i>	Past Due	Past Due Over 90 Days		Total Past Due	Current	Total Loans
	30-89 Days	Accruing	Non- Accruing			
Real estate						
Construction	\$ 420	\$ -	\$ 8,194	\$ 8,614	\$ 34,706	\$ 43,320
Residential	816	-	3,852	4,668	76,302	80,970
Nonresidential	5,640	328	9,437	15,405	118,198	133,603
Total real estate loans	6,876	328	21,483	28,687	229,206	257,893
Commercial	542	-	1,300	1,842	34,623	36,465
Consumer and other	38	-	2	40	9,000	9,040
Totals	\$ 7,456	\$ 328	\$ 22,785	\$ 30,569	\$ 272,829	\$ 303,398

At December 31, 2012 and December 31, 2011 loans past due 90 days and still accruing interest totaled \$5,729 and \$327,899, respectively.

Loans totaling \$20,973,813 and \$22,784,773 were in nonaccruing status at December 31, 2012 and 2011, respectively. When the ultimate collectability of a nonaccrual loan principal is in doubt, wholly or partially, all cash receipts are applied to the principal. When this doubt does not exist, cash receipts are applied under the contractual terms of the loan agreement.

Included in the loan portfolio are particular loans that have been modified in order to maximize the collection of loan balances. If, for economic or legal reasons related to the customer's financial difficulties, the Company grants a

concession compared to the original terms and conditions on the loan, the modified loan is classified as a troubled debt restructuring (“TDR”).

At December 31, 2012 there were 52 loans classified as TDRs totaling \$15,155,121. Of the 52 loans, seven loans totaling \$3,128,542 were performing while 45 loans totaling \$12,026,579 were not performing. As of December 31, 2011 there were 37 loans classified as TDRs totaling \$7,258,698. Of the 37 loans, 15 loans totaling \$3,163,205 were performing while 22 loans totaling \$4,095,493 were not performing. All restructured loans resulted in either extended maturity or lowered rates and were included in the impaired loan balance.

The following table provides, by class, the number of loans modified in troubled debt restructurings during the year ended December 31, 2012 and 2011.

	<i>(Dollars in Thousands)</i> For The Year Ended December 31, 2012			For the Year Ended December 31, 2011		
	Number of Loans	Recorded Investment	Unpaid Principal Balance	Number of Loans	Recorded Investment	Unpaid Principal Balance
Extended maturity						
Real estate –						
Construction	6	\$ 4,843	\$ 4,862	3	\$ 848	\$ 913
Residential	6	2,560	2,745	12	3,412	3,412
Nonresidential	4	1,777	1,834	-	-	-
Commercial	1	110	110	1	29	29
Consumer and other	5	312	317	1	23	23
Total	22	9,602	9,868	17	4,312	4,377

	For The Year Ended December 31, 2012			For the Year Ended December 31, 2011		
	Number of Loans	Recorded Investment	Unpaid Principal Balance	Number of Loans	Recorded Investment	Unpaid Principal Balance
Reduced Rate						
Real estate –						
Construction	-	-	-	1	420	420
Residential	2	92	92	5	832	832
Nonresidential	2	446	566	4	1,017	1,017
Commercial	2	1,588	1,588	2	99	99
Total	6	2,126	2,246	12	2,368	2,368
Totals	28	\$ 11,728	\$ 12,114	29	\$ 6,680	\$ 6,745

The following table provides the number of loans and leases modified in troubled debt restructurings during the previous 12 months which subsequently defaulted during the years ended December 31, 2012 and 2011, as well as the recorded investments and unpaid principal balances as of December 31, 2012 and 2011. Loans in default are those past due greater than 89 days.

	For The Year Ended December 31, 2012			For the Year Ended December 31, 2011		
	Number of Loans	Recorded Investment	Unpaid Principal Balance	Number of Loans	Recorded Investment	Unpaid Principal Balance
Extended Maturity						
Real estate –						
Construction	6	\$ 3,013	\$ 3,031	3	\$ 848	\$ 913
Residential	9	2,343	2,344	-	-	-
Nonresidential	6	1,809	1,809	8	1,312	1,678
Commercial	2	231	231	1	29	29
Consumer and other	3	92	92	-	-	-
Total	26	7,488	7,507	12	2,189	2,620
Reduced Rate						
Real estate –						
Residential	2	471	591	5	832	832
Nonresidential	2	534	534	3	975	975
Commercial	2	1,733	1,733	2	99	99
Consumer and other	1	4	4	-	-	-
Total	7	2,782	2,902	10	1,906	1,906
Totals	33	\$ 10,270	\$ 10,409	22	\$ 4,095	\$ 4,526



All loans modified in troubled debt restructurings are evaluated for impairment. The nature and extent of impairment of TDRs, including those which have experienced a subsequent default, are considered in determining an appropriate level of allowance for credit losses.

### **Credit Indicators**

Loans are categorized into risk categories based on relevant information about the ability of borrowers to service their debt, including: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The following definitions are utilized for risk ratings, which are consistent with the definitions used in supervisory guidance:

**Special Mention** - Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard** - Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful** - Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

As of December 31, 2012, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

(Dollars in Thousands)	Real Estate Loans				Total Real Estate Loans	Commercial	Consumer and Other
	Total	Constructi	Residential	Non- Residential			
Pass	\$200,723	\$19,871	\$ 54,280	\$ 90,871	\$165,022	\$ 26,407	\$ 9,294
Special mention	29,371	7,931	6,534	14,421	28,886	423	62
Substandard	30,163	4,183	6,421	17,018	27,622	2,426	115
Doubtful	-	-	-	-	-	-	-
Totals	\$260,257	\$31,985	\$ 67,235	\$ 122,310	\$221,530	\$ 29,256	\$ 9,471

As of December 31, 2011, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

(Dollars in Thousands)	Real Estate Loans				Total Real Estate Loans	Commercial	Consumer and Other
	Total	Constructi	Residential	Non- Residential			
Pass	\$237,537	\$26,767	\$ 66,961	\$ 103,120	\$196,848	\$ 31,811	\$ 8,878
Special mention	32,444	6,719	6,623	17,655	30,997	1,356	91
Substandard	33,417	9,834	7,386	12,828	30,048	3,298	71
Doubtful	-	-	-	-	-	-	-
Totals	\$303,398	\$43,320	\$ 80,970	\$ 133,603	\$257,893	\$ 36,465	\$ 9,040

The Company enters into financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. A commitment involves, to varying degrees, elements of credit and interest

rate risk in excess of the amount recognized in the balance sheet. The Company's exposure to credit loss in the event of nonperformance by the other parties to the instrument is represented by the contractual notional amount of the instrument. Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company uses the same credit policies in making commitments to extend credit as it does for on-balance-sheet instruments. Letters of credit are conditional commitments issued to guarantee a customer's performance to a third party and have essentially the same credit risk as other lending facilities.

Collateral held for commitments to extend credit and standby letters of credit varies but may include accounts receivable, inventory, property, plant, equipment, and income-producing commercial properties.

The following table summarizes the Company's off-balance sheet financial instruments whose contract amounts represent credit risk:

	December 31,	
	2012	2011
Commitments to extend credit	\$28,919,003	\$34,523,727
Standby letters of credit	8,000	1,595,656

The Company originates certain fixed rate residential mortgage loans and commits these loans for sale based on best efforts contracts. The commitments to originate fixed rate residential mortgage loans and the sales commitments are freestanding derivative instruments. At December 31, 2012 and 2011, the Company has no material embedded derivative instruments requiring separate accounting treatment. At December 31, 2012 and 2011, the amount of the forward sales commitments approximates the carrying value of the mortgage loans held for sale of \$5,621,860 and \$2,863,297, respectively. Sales commitments are to sell loans at an agreed upon price and are generally funded within 60 days.

**NOTE 5 - PREMISES, FURNITURE AND EQUIPMENT**

Premises, furniture and equipment consisted of the following:

	December 31,	
	2012	2011
Land	\$10,768,061	\$10,832,561
Buildings	13,712,374	13,696,055
Leasehold improvements	511,842	511,842
Furniture and equipment	5,740,752	5,572,598
Construction in progress	1,110,975	1,001,892
Total	31,844,004	31,614,948
Less, accumulated depreciation	7,217,029	6,409,884
Premises and equipment, net	\$24,626,975	\$25,205,064

Depreciation expense for the years ended December 31, 2012 and 2011 amounted to \$820,116 and \$864,411, respectively.

At December 31, 2012 and 2011, construction in progress consists mainly of architect fees and site work for potential new branches. As of December 31, 2012, there were no material commitments outstanding for the construction/or purchase of premises, furniture and equipment. Also, there were no material sales of premises, furniture or equipment during 2012 or 2011.

**NOTE 6 - OTHER REAL ESTATE OWNED**

Transactions in other real estate owned for the years ended December 31, 2012 and 2011 are summarized below:

	December 31,	
	2012	2011
Beginning balance	\$22,135,921	\$14,669,051
Additions	6,596,760	14,049,177
Improvements made to properties	-	6,987
Sales	(12,251,603)	(5,485,039)
Write downs	(1,191,087)	(1,104,255)
Ending balance	\$15,289,991	\$22,135,921

For the years ended December 31, 2012 and 2011, other real estate owned having a carrying value of \$12,251,603 and \$5,485,039, respectively, was sold for \$12,089,602 and \$5,427,221, respectively. The Company recognized a net loss of \$162,001 and \$57,818 on these sales for the years ended December 31, 2012 and 2011, respectively.

Other real estate owned expense for the years ended December 31, 2012 and 2011 was \$1,946,441 and \$2,469,772, respectively, which includes gains and losses on sales.

NOTE 7 - DEPOSITS

At December 31, 2012, the scheduled maturities of time deposits were as follows:

Maturing In	Amount
2013	\$ 105,683,063
2014	25,831,864
2015	11,775,138
2016	594,525
2017	806,342
Total	\$ 144,690,932

Included in total time deposits at December 31, 2012 and 2010 were brokered time deposits of \$57,885,000 and \$90,860,000, respectively.

**NOTE 8 – SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE**

Securities sold under agreements to repurchase generally mature on a one to thirty day basis. Under the terms of the repurchase agreement, the Company sells an interest in securities issued by United States Government agencies and agrees to repurchase the same securities the following business day. Information concerning securities sold under agreements to repurchase is summarized as follows:

	December 31,	
	2012	2011
Balance at end of the year	\$4,377,978	\$ -
Maximum month-end balance during the year	4,892,144	-
Average balance during the year	3,566,353	-
Average interest rate at the end of the year	0.10	% - %
Average interest rate during the year	0.10	% - %

As of December 31, 2012 and 2011, the par value and market value of the securities pledged for the underlying agreements were \$5,535,000 and \$5,730,496, respectively, and \$5,535,000 and \$5,837,402, respectively.

**NOTE 9 - ADVANCES FROM FEDERAL HOME LOAN BANK**

Advances from the Federal Home Loan Bank consisted of the following:

	Interest Rate	December 31,	
		2012	2011
Fixed rate advances maturing:			
October 1, 2012	0.63 %	\$-	\$2,000,000
October 1, 2013	1.00 %	10,000,000	10,000,000
October 1, 2014	2.93 %	1,000,000	1,000,000
		\$11,000,000	\$13,000,000

Scheduled principal reductions of Federal Home Loan Bank advances as of December 31, 2012 are as follows:

Amount
2013 \$10,000,000
2014 1,000,000
Total \$11,000,000

At December 31, 2012 and 2011 the Company has pledged certain loans totaling \$54,941,097 and \$35,976,783, respectively, as collateral to secure its borrowings from the Federal Home Loan Bank. Investment securities with a par value of \$3,679,851 and \$4,862,173 and a fair market value of \$4,024,817 and \$5,221,298 were also pledged as collateral to secure the borrowings at December 31, 2012 and 2011, respectively. Additionally, the Company's Federal Home Loan Bank stock is pledged to secure the borrowings.

**NOTE 10 - Junior Subordinated Debentures**

On June 30, 2005, the Trust (a non-consolidated affiliate) issued \$10,000,000 in trust preferred securities (callable without penalty) with a maturity of November 23, 2035. Interest on these securities is payable quarterly at the three-month LIBOR rate plus 1.83%. In accordance with generally accepted accounting principles, 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.

The Company MOU requires the Company to obtain approval of the Federal Reserve Bank prior to paying interest. The Federal Reserve did not approve the Company's request to pay interest relating to its trust preferred securities due and payable in the fourth quarter of 2011 and for the year 2012. Additionally, the Federal Reserve Bank did not approve the Company's request to pay interest on these securities for the first quarter of 2013. See Note 18 – Regulatory Matters – *Memoranda of Understanding*.

NOTE 11 – SHAREHOLDERS’ EQUITY

**Common Stock** – The following is a summary of the changes in common shares outstanding for the years ended December 31, 2012 and 2011.

	2012	2011
Common shares outstanding at beginning of the period	4,084,400	4,115,903
Issuance of common stock	2,970	942
Issuance of non-vested restricted shares	13,627	20,000
Forfeiture of restricted shares	(6,136 )	(52,445 )
Common shares outstanding at end of the period	4,094,861	4,084,400

**Preferred Stock** - The Company’s Articles of Incorporation authorizes the issuance of a class of 10,000,000 shares of preferred stock, having no par value. Subject to certain conditions, the Company’s Board of Directors is authorized to issue preferred stock without shareholders’ approval. Under the Articles of Incorporation, the Board is authorized to determine the terms of one or more series of preferred stock, including the preferences, rights, and limitations of each series.

On March 6, 2009, the Company completed a transaction with the United States Treasury (the “Treasury”) under the Troubled Asset Relief Program Capital Purchase Program (“TARP CPP”), which was amended by the enactment of the American Recovery and Reinvestment Act of 2009 on February 17, 2009. Under the TARP CPP, the Company sold 15,349 shares of its Series A Cumulative Perpetual Preferred Stock. In addition, the Treasury received a warrant to purchase 767 shares of the Company’s Series B Cumulative Perpetual Preferred Stock, which was immediately exercised by the Treasury for a nominal exercise price. The preferred shares issued to the Treasury qualify as Tier 1 capital for regulatory purposes.

The Series A Preferred Stock is a senior cumulative perpetual preferred stock that has a liquidation preference of \$1,000 per share, pays cumulative dividends at a rate of 5% per year for the first five years and thereafter at a rate of 9% per year. Dividends are payable quarterly. At any time, the Company may, at its option and with regulatory approval, redeem the Series A Preferred Stock at par value plus accrued and unpaid dividends. The Series A Preferred Stock is generally non-voting. Prior to March 6, 2012, unless the Company has redeemed the Series A Preferred Stock or the Treasury has transferred the Series A Preferred Stock to a third party, the consent of the Treasury would have been required for the Company to increase its common stock dividend or repurchase its common stock or other equity or capital securities, other than in connection with benefit plans consistent with past practices and certain other circumstances. A consequence of the Series A Preferred Stock purchase includes certain restrictions on executive compensation that could limit the tax deductibility of compensation the Company pays to executive management.



The Series B Preferred Stock is a cumulative perpetual preferred stock that has the same rights, preferences, privileges, voting rights and other terms as the Series A Preferred Stock, except that dividends will be paid at the rate of 9% per year and may not be redeemed until all the Series A Preferred Stock has been redeemed.

The Series C Preferred Stock consists of 7% cumulative mandatory convertible preferred stock, which will be convertible into common shares for up to three years at the lesser of \$6.50 per share or tangible common equity per share as of the calendar quarter ending on or before the conversion date and will mandatorily and automatically convert on July 31, 2013 under the same terms. Dividends are payable quarterly on March 1, June 1, September 1, and December 1 of each year. The Series C Preferred Stock ranks on par with the Company's Series A and Series B Preferred Stock and senior to the common stock with respect to the payment of dividends and distributions and amounts payable upon liquidation, dissolution, and winding up of the Company. The Series C Preferred Stock is non-voting, except as required by law.

The proceeds from the issuance of the Series A Preferred Stock and Series B Preferred Stock were allocated based on the relative fair value of each series based on a discounted cash flow model. As a result of the valuations, \$14,492,526 and \$856,474 was allocated to the Series A Preferred Stock and Series B Preferred Stock, respectively. This resulted in a discount of \$973,260 for the Series A Preferred Stock and a premium of \$82,572 for the Series B Preferred Stock. The discount and premium are being accreted and amortized, respectively, through retained earnings over a five-year estimated life using the effective interest method.

Beginning with the payment date of December 1, 2011, the Company deferred dividend payments on the TARP preferred stock. Although the Company may defer dividend payments, the dividend is a cumulative dividend and failure to pay dividends for six dividend periods would trigger board appointment rights for the holder of the TARP stock. As of the first quarter of 2013, the Company has not paid dividends on any of its classes of its preferred stock for six quarters.

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 \$1.3 million) prior to payment of any dividend or other distribution to holders of *pari passu* or junior stock, including the Company's Fixed Rate Cumulative Mandatorily Convertible Preferred Stock, Series C, and its 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.



The following is a summary of the accretion of the Series A Preferred Stock discount and the amortization of the Series B Preferred Stock premium for the years ended December 31, 2012 and 2011.

	2012	2011
Accretion of Series A Preferred Stock discount	\$ 195,078	\$ 194,545
Amortization of Series B Preferred Stock premium	(16,551 )	(16,505 )
Accretion net of amortization	\$ 178,527	\$ 178,040

The net amount of the accretion and amortization was treated as a deemed dividend to preferred shareholders in the computation of loss per share.

**Restrictions on Shareholders' Equity**- South Carolina banking regulations restrict the amount of dividends that can be paid to shareholders. All of the Bank's dividends to First Reliance Bancshares, Inc. are payable only from the undivided profits of the Bank. At December 31, 2012, the Bank had negative undivided profits of \$576,032. The Bank is authorized to upstream 100% of net income in any calendar year without obtaining the prior approval of the SC State Board provided that the Bank received a composite CAMELS rating of one or two at the last Federal or State regulatory examination. Under Federal Reserve regulations, the amounts of loans or advances from the Bank to the parent company are also restricted. Please see "Management's Discussion and Analysis – Liquidity Management and Capital Resources" appearing above for additional information relating to the Company's payment of dividends.

#### **NOTE 12- OTHER OPERATING EXPENSE**

Other operating expenses are summarized below:

	December 31,	
	2012	2011
Advertising	\$ 151,298	\$ 239,952
Office supplies and printing	145,092	204,410
Computer supplies and software amortization	145,292	113,415
Telephone	302,039	273,702
Professional fees and services	975,780	1,025,660
Meetings and travel expenses	147,955	234,734
Supervisory fees and assessments	737,204	995,634
Debit and credit card expenses	683,691	480,726
Other real estate owned expenses	1,946,441	2,469,772
Mortgage loan expenses	1,028,240	1,090,922
Other	1,612,474	1,562,807

Total	\$7,875,506	\$8,691,734
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NOTE 13 - INCOME TAXES

Income tax expense for the years ended December 31, 2012 and 2011 is summarized as follows:

	2012	2011
Currently payable		
Federal	\$-	\$16,386
State	6,751	-
Total current	6,751	16,386
Deferred income taxes	(197,200)	6,329,386
Total income tax expense	\$(190,449)	\$6,345,772

Income tax expense (benefit) is allocated as follows:

To continuing operations	\$6,751	\$5,134,705
To shareholders' equity	(197,200)	1,211,067
Total income tax expense	\$(190,449)	\$6,345,772

The components of deferred tax assets and deferred tax liabilities are as follows:

	December 31,	
	2012	2011
Deferred tax assets:		
Allowance for loan losses	\$1,416,943	\$2,632,780
Net operating losses	5,641,912	4,158,211
Non-accrual interest	1,039,730	1,243,193
Deferred compensation	514,015	592,624
Federal and state credits	459,130	464,005
Other real estate owned	424,280	305,240
Other	56,099	44,025
Gross deferred tax assets	9,552,109	9,440,078
Less, valuation allowance	(7,459,272)	(7,286,724)
Net deferred tax assets	2,092,837	2,153,354

	December 31,	
	2012	2011
Deferred tax liabilities:		
Accumulated depreciation	493,948	539,784
Prepaid expenses	178,563	188,890
Unrealized gains on securities available for sale	702,293	899,493
Other	23,326	27,680
Total gross deferred tax liabilities	1,398,130	1,655,847
Net deferred tax asset recognized	\$694,707	\$497,507

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. After review of all positive and negative factors and potential tax planning strategies, as of December 31, 2011, management had recorded a partial valuation allowance of \$7,286,724. During 2012, the valuation allowance increased by \$172,548 and the valuation allowance was \$7,459,272 at December 31, 2012. Net deferred tax assets are included in other assets at December 31, 2012 and 2011.

The Company has federal net operating losses of \$16,147,260 and \$11,824,182 for the years ended December 31, 2012 and 2011, respectively. The Company has state net operating losses of \$4,601,341 and \$4,181,482 for the years ended December 31, 2012 and 2011, respectively.

A reconciliation between the income tax expense (benefit) and the amount computed by applying the federal statutory rate of 34% to income before income taxes for the years ended December 31, 2012 and 2011 follows:

	2012	2011
Tax expense (benefit) at statutory rate	\$96,245	\$(1,443,779)
State income tax, net of federal income tax benefit	7,109	(1,052 )
Tax-exempt interest income	(171,200)	(506,988 )
Disallowed interest expense	7,795	28,684
Life insurance surrender value	(126,125)	(136,297 )
Valuation allowance	172,548	7,149,787
Other, net	20,379	44,350
	\$6,751	\$5,134,705

The Company had analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions. Tax returns for 2009 and subsequent years are subject to review by taxing authorities.

#### **NOTE 14 - RELATED PARTY TRANSACTIONS**

Certain parties (principally certain directors and executive officers of the Company, their immediate families and business interests) were loan customers of and had other transactions in the normal course of business with the Company. In compliance with relevant law and regulations, the Company's related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collectability. As of December 31, 2012 and 2011, the Company had related party loans totaling \$2,007,375 and \$2,233,053, respectively. During 2012, \$93,844 of advances were made to related parties and repayments totaled \$319,522. As of December 31, 2012, all related party loans were current.

Deposits from directors and executive officers and their related interests totaled \$1,859,942 and \$1,102,081 at December 31, 2012 and 2011, respectively.

**NOTE 15 - COMMITMENTS AND CONTINGENCIES**

In the ordinary course of business, the Company may, from time to time, become a party to legal claims and disputes. At December 31, 2012, management and legal counsel are not aware of any pending or threatened litigation or unasserted claims or assessments that could result in losses, if any, that would be material to the consolidated financial statements.

The Company has entered into a number of operating leases for properties relating to its branch banking and mortgage operations. The leases have various initial terms and expire on various dates. The lease agreements generally provide that the Company is responsible for ongoing repairs and maintenance, insurance and real estate taxes. The leases also provide for renewal options and certain scheduled increases in monthly lease payments. Rental expenses recorded under leases for the years ended December 31, 2012 and 2011 were \$373,667 and \$372,356, respectively.

The minimal future rental payments under non-cancelable operating leases having remaining terms in excess of one year, for each of the next five years and thereafter in the aggregate are:

	Amount
2013	\$388,528
2015	350,842
2015	320,000
2016	345,000
2017	345,000
Thereafter	4,673,982
Total	\$6,423,352

**NOTE 16 - EQUITY INCENTIVE PLAN**

On January 19, 2006, the Company adopted the 2006 Equity Incentive Plan, which provides for the granting of dividend equivalent rights options, performance unit awards, phantom shares, stock appreciation rights and stock awards, each of which are subject to such conditions based upon continued employment, passage of time or satisfaction of performance criteria or other criteria as permitted by the plan. The plan, as amended on September 17, 2010, allows the Company to award, subject to approval by the Board of Directors, up to 950,000 shares of stock, to

officers, employees, and directors, consultants and service providers of the Company or its affiliates. Awards may be granted for a term of up to ten years from the effective date of grant. Under this Plan, our Board of Directors has sole discretion as to the exercise date of any awards granted. The per-share exercise price of incentive stock awards may not be less than the market value of a share of common stock on the date the award is granted. Any awards that expire unexercised or are canceled become available for re-issuance.

The Company can issue the restricted shares as of the grant date either by the issuance of share certificate(s) evidencing restricted shares or by documenting the issuance in uncertificated or book entry form on the Company's stock records. Except as provided by the Plan, the employee does not have the right to make or permit to exist any transfer or hypothecation of any restricted shares. When restricted shares vest, the employee must either pay the Company within two business days the amount of all tax withholding obligations imposed on the Company or make an election pursuant to Section 83(b) of the Internal Revenue Code to pay taxes at grant date.

Restricted shares may be subject to one or more objective employment, performance or other forfeiture conditions established by the Plan Committee at the time of grant. The restricted shares will not vest unless the Company's retained earnings at the end of the fiscal quarter preceding the third anniversary of the restricted share award date are greater than the award value of the restricted shares. Any shares of restricted stock that are forfeited will again become available for issuance under the Plan. An employee or director has the right to vote the shares of restricted stock after grant until they are forfeited or vested. Compensation cost for restricted stock is equal to the market value of the shares at the date of the award and is amortized to compensation expense over the vesting period. Dividends, if any, will be paid on awarded but unvested stock.



During 2012 and 2011, the Company issued 13,627 and 20,000 shares, respectively, of restricted stock pursuant to the 2006 Equity Incentive Plan. The shares cliff vest in three years, and are fully vested in 2015 and 2014, respectively. The weighted-average fair value per share of restricted stock issued during 2012 and 2011 was \$1.05 and \$2.20, respectively. Compensation cost associated with the issuances was \$14,308 and \$44,000 for the years ended December 31, 2012 and 2011, respectively. During 2012 and 2011, 6,136 and 52,445 shares were forfeited having a weighted average price of \$3.35 and \$3.70, respectively. Shares vested in 2012 and 2011 were 56,527 and 10,897, respectively. Compensation cost amortized to expense for 2012 and 2011 was \$190,477 and \$208,774, respectively.

The 2006 Equity Incentive Plan allows for the issuance of Stock Appreciation Rights ("SARs"). The SARs entitle the participant to receive the excess of (1) the market value of a specified or determinable number of shares of the stock at the exercise date over the fair value at grant date or (2) a specified or determinable price which may not in any event be less than the fair market value of the stock at the time of the award. Upon exercise, the Company can elect to settle the awards using either Company stock or cash. The shares start vesting after five years and vest at 20% per year until fully vested. Compensation cost for SARs is amortized to compensation expense over the vesting period.

During the first quarter of 2012, the Board of Directors cancelled all 84,334 SARs that were outstanding at December 31, 2011. Holders of these SARs were given cash and restricted stock totaling \$37,500 in exchange for the cancellation. The cancellation resulted in the removal of all accrued SARs expense and related unrecognized compensation costs. For the year ended December 31, 2012, net income of \$337,153 was recognized as a result of the cancellation. The SARs compensation expense for the year ended December 31, 2011 was \$49,222.

At December 31, 2012, there were 773,796 stock awards available for grant under the 2006 Equity Incentive Plan.

#### **NOTE 17 - LOSS PER COMMON SHARE**

Net loss available to common shareholders represents net loss adjusted for preferred dividends including dividends declared, accretions of discounts and amortization of premiums on preferred stock issuances and cumulative dividends related to the current dividend period that have not been declared as of period end. All potential dilutive common shares equivalents were deemed to be anti-dilutive for the years ended December 31, 2012 and 2011 due to the net loss for each year.

The following is a summary of the loss per common share calculations for the years ended December 31, 2012 and 2011.

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	2012	2011
Loss available to common shareholders		
Net income (loss)	\$275,840	\$(9,381,115 )
Preferred stock dividends	996,990	996,990
Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium	178,527	178,040
Net loss available to common shareholders	\$(899,677 )	\$(10,556,145)
Basic loss per common share:		
Net loss available to common shareholders	\$(899,677 )	\$(10,556,145)
Average common shares outstanding – basic	4,093,892	4,100,972
Basic loss per common share	\$(0.22 )	\$(2.57 )
Diluted loss per common share:		
Net loss available to common shareholders	\$(899,677 )	\$(10,556,145)
Average common shares outstanding – basic	4,093,892	4,100,972
Dilutive potential common shares	-	-
Average common shares outstanding – diluted	4,093,892	4,100,972
Diluted loss per common share	\$(0.22 )	\$(2.57 )

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**NOTE 18 - REGULATORY MATTERS**

**Capital Requirements** - The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk-weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum ratios (set forth in the table below) of Tier 1 and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk-weights ranging from 0% to 100%. Tier 1 capital of the Company and the Bank consists of common shareholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets. Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital.

The Company and the Bank are also required to maintain capital at a minimum level based on average assets (as defined), which is known as the leverage ratio. Only the strongest institutions are allowed to maintain capital at the minimum requirement of 3%. All others are subject to maintaining ratios at least 1% to 2% above the minimum.

As of the most recent regulatory examination, the Bank was deemed well-capitalized under the regulatory framework for prompt corrective action. To be categorized well-capitalized for regulatory purposes, the Bank must maintain total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events that management believes have changed the Bank's categories. Additional information related to our capitalization and regulatory requirements is provided in "Management's Discussion and Analysis – Capital" appearing above.

The following table summarizes the capital amounts and ratios of the Company and the Bank and the regulatory minimum requirements.

(Dollars in Thousands)	Actual	For Capital Adequacy Purposes Minimum	To Be Well Capitalized Under Prompt Corrective Action Provisions Minimum
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	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2012						
The Company						
Total capital (to risk-weighted assets)	\$53,963	17.16%	\$ 25,154	8.00 %	N/A	N/A
Tier 1 capital (to risk-weighted assets)	50,030	15.91	12,577	4.00	N/A	N/A
Tier 1 capital (to average assets)	50,030	11.48	17,436	4.00	N/A	N/A
The Bank						
Total capital (to risk-weighted assets)	\$49,307	15.72%	\$ 25,095	8.00 %	\$31,369	10.00 %
Tier 1 capital (to risk-weighted assets)	45,383	14.47	12,547	4.00	18,821	6.00
Tier 1 capital (to average assets)	45,383	10.40	17,460	4.00	21,825	5.00
December 31, 2011						
The Company						
Total capital (to risk-weighted assets)	\$54,180	14.80%	\$ 29,281	8.00 %	N/A	N/A
Tier 1 capital (to risk-weighted assets)	49,566	13.54	14,641	4.00	N/A	N/A
Tier 1 capital (to average assets)	49,566	9.85	20,123	4.00	N/A	N/A
The Bank						
Total capital (to risk-weighted assets)	\$49,670	13.59%	\$ 29,239	8.00 %	\$36,548	10.00 %
Tier 1 capital (to risk-weighted assets)	45,062	12.33	14,619	4.00	21,929	6.00
Tier 1 capital (to average assets)	45,062	8.96	20,123	4.00	25,154	5.00

*Memoranda of Understanding* - Following an examination of the Bank by the Federal Deposit Insurance Corporation (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 South Carolina Commissioner of Banks ("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, which the Company entered into in December 2010 (the "Company MOU"). While this agreement provides for many of the same measures suggested by the Memorandum already in place for the Bank, the Company MOU requires that the Company seek pre-approval from the Federal Reserve Bank prior to the declaration or 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 completed in 2010. This provision will also apply to the Company's common stock, although to date, the Company has not elected to pay dividends 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; however, the Federal Reserve did not approve the Company's request to pay dividends and interest payments relating to its outstanding classes of preferred stock and trust preferred securities due and payable in the fourth quarter of 2011 and for the four quarters of 2012. Also, such approval was not granted for payments due in the first quarter of 2013. As a result, no assurance can be given as to the ability of the Company to 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. Should the Company not pay the dividend on its preferred stock held by the U. S. Treasury for six quarterly periods, the holder of the Company's Series A and Series B Preferred Stock will have the right to appoint up to two directors to the Company's board of directors. As of the first quarter of 2013, the Company has not paid dividends on any of its preferred stock for six quarters.

In response to these regulatory matters, the Bank and the Company have taken various actions designed to improve our lending procedures, nonperforming assets, liquidity and capital position and other conditions related to our operations, which are more fully described in turn as part of the section titled "Management's Discussion and Analysis" above. We believe that the successful completion of these initiatives will result in full compliance with our regulatory obligations with the FDIC, the SC State Board and the Federal Reserve Bank and position us well for stability and growth over the long term.

**NOTE 19 - UNUSED LINES OF CREDIT**

As of December 31, 2012, the Bank had the ability to borrow funds from the Federal Home Loan Bank of up to \$131,700,000. At that date \$11,000,000 had been advanced. Additionally, an unused line of credit of \$5,000,000 was available from the Federal Reserve. Both of these lines can be revoked at lender's discretion.

**NOTE 20 - FAIR VALUE MEASUREMENTS**

Generally accepted accounting principles ("GAAP") provide a framework for measuring and disclosing fair value that requires disclosures about the fair value of assets and liabilities recognized in the balance sheet, whether the measurements are made on a recurring basis (for example, available-for-sale investment securities) or on a nonrecurring basis (for example, impaired loans).

Fair value is defined as the exchange in price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company utilizes fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of the lower of cost or market accounting or the writing down of individual assets.

The following methods and assumptions were used to estimate the fair value of significant financial instruments:

### **Fair Value Hierarchy**

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These levels are:

**Level 1 -** Valuation is based upon quoted prices for identical instruments traded in active markets.

Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or  
**Level 2 -** similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Valuation is generated from model-based techniques that use at least one significant assumption not  
**Level 3 -** observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

### **Assets Recorded at Fair Value on a Recurring Basis**

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

**Securities Available-for-Sale** - Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the counter markets and money market funds. Level 2 securities include mortgage backed securities issued by government sponsored

entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

**Loans** - The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2012 and December 31, 2011, a significant portion of impaired loans were evaluated based upon the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

**Mortgage Loans Held for Sale** - The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

**Other Real Estate Owned** - Foreclosed assets are adjusted to fair value upon transfer of the loans to other real estate owned. Real estate acquired in settlement of loans is recorded initially at estimated fair value of the property less estimated selling costs at the date of foreclosure. The initial recorded value may be subsequently reduced by additional allowances, which are charges to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.



The tables below present the balances of assets and liabilities measured at fair value on a recurring basis by level within the hierarchy at December 31, 2012 and 2011.

	Total	Level 1	Level 2	Level 3
December 31, 2012				
Available-for-sale securities:				
U.S. Government sponsored agencies	\$8,109,028	\$ -	\$8,109,028	\$ -
Mortgage-backed securities	51,956,484	-	51,956,484	-
Equity security	5,500	-	5,500	-
	60,071,012	-	60,071,012	-
Mortgage loans held for sale (1)	5,621,860	-	5,621,860	-
	\$65,692,872	\$ -	\$65,692,872	\$ -

(1) Carried at the lower of cost or market.

December 31, 2011				
Available-for-sale securities:				
U.S. Government sponsored agencies	\$3,024,945	\$ -	\$3,024,945	\$ -
Mortgage-backed securities	61,560,402	-	61,560,402	-
Municipals	19,937,971	-	19,937,971	-
Equity security	11,000	-	11,000	-
	84,534,318	-	84,534,318	-
Mortgage loans held for sale (1)	2,863,297	-	2,863,297	-
	\$87,397,615	\$ -	\$87,397,615	\$ -

(1) Carried at the lower of cost or market.

There were no liabilities measured at fair value on a recurring basis at December 31, 2012 and December 31, 2011.

#### Assets Recorded at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2012 and December 31, 2011, aggregated by level in the fair value hierarchy within which those measurements fall.

	Total	Level 1	Level 2	Level 3
December 31, 2012				
Collateral dependent impaired loans receivable	\$18,951,232	\$ -	\$ -	\$18,951,232
Other real estate owned	15,289,991	-	-	15,289,991

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Total assets at fair value	\$34,241,223	\$ -	\$ -	\$34,241,223
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	Total	Level 1	Level 2	Level 3
December 31, 2011				
Collateral dependent impaired loans receivable	\$23,837,812	\$ -	\$ -	\$23,837,812
Other real estate owned	22,135,921	-	-	22,135,921
Total assets at fair value	\$45,973,733	\$ -	\$ -	\$45,973,733

For level 3 assets measured at fair value on a non-recurring basis as of December 31, 2012 and 2011, the significant unobservable inputs in the fair value measurements were as follows:

	Valuation Technique	Significant Unobservable Inputs	General Range	
Collateral-dependant impaired loans receivable	Appraised Value	Collateral discounts	0-10	%
Other real estate owned	Appraised Value	Collateral discounts and estimated costs to sell	0-10	%

There were no liabilities measured at fair value on a nonrecurring basis at December 31, 2012 and December 31, 2011.

## Disclosures about Fair Value of Financial Instruments

The following describes the valuation methodologies used by the Company for estimating fair value of financial instruments not recorded at fair value in the balance sheet on a recurring or nonrecurring basis:

***Cash and Due from Banks and Interest-bearing Deposits with Other Banks*** - The carrying amount is a reasonable estimate of fair value.

***Time Deposits in other Banks*** - The carrying amount is a reasonable estimate of fair value.

***Nonmarketable Equity Securities*** - The carrying amount of nonmarketable equity securities is a reasonable estimate of fair value since no ready market exists for these securities.

***Loans Receivable*** – For certain categories of loans, such as variable rate loans which are repriced frequently and have no significant change in credit risk, fair values are based on the carrying amounts. The fair value of other types of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

***Deposits*** - The fair value of demand deposits, savings, and money market accounts is the amount payable on demand at the reporting date. The fair values of certificates of deposit are estimated using a discounted cash flow calculation that applies current interest rates to a schedule of aggregated expected maturities.

***Securities Sold Under Agreements to Repurchase*** - The carrying amount is a reasonable estimate of fair value because these instruments typically have terms of one day.

***Advances From Federal Home Loan Bank*** - The fair values of fixed rate borrowings are estimated using a discounted cash flow calculation that applies the Company's current borrowing rate from the Federal Home Loan Bank. The carrying amounts of variable rate borrowings are reasonable estimates of fair value because they can be repriced frequently.

**Junior Subordinated Debentures** - The carrying value of the junior subordinated debentures approximates their fair value since they were issued at a floating rate.

**Accrued Interest Receivable and Payable** - The carrying value of these instruments is a reasonable estimate of fair value.

**Off-Balance Sheet Financial Instruments** - Fair values of off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of December 31, 2012 and December 31, 2011. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity.

	Carrying Amount	Fair Value	Fair Value Measurements		
			Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2012					
Financial Assets:					
Loans receivable	\$260,257,334	\$258,758,000	\$-	\$-	\$258,758,000
Financial Liabilities:					
Certificates of deposit	\$144,690,932	\$146,539,000	\$-	\$146,539,000	\$-
Advances from Federal Home Loan Bank	11,000,000	11,077,000	-	11,077,000	-

			Fair Value Measurements		
			Quoted		
			Prices		
			in		
			Active		
			Markets		
			for	Other	Significant
			Identical	Assets	Unobservable
			or	Observable	Inputs
	Carrying	Fair	Liabilities	Inputs	
	Amount	Value	(Level 1)	(Level 2)	(Level 3)
December 31, 2011					
Financial Assets:					
Loans receivable	\$303,398,403	\$305,701,000	\$-	\$-	\$305,701,000
Financial Liabilities:					
Certificates of deposit	\$210,896,717	\$215,293,000	\$-	\$215,293,000	\$-
Advances from Federal Home Loan Bank	13,000,000	13,050,000	-	13,050,000	-

**NOTE 21 - SUBSEQUENT EVENTS**

In preparing these financial statements, subsequent events were evaluated through the time the financial statements were issued. Financial statements are considered issued when they are widely distributed to all shareholders and other financial statement users, or filed with the Securities and Exchange Commission. In conjunction with applicable accounting standards, all material subsequent events have been either recognized in the financial statements or disclosed in the notes to the financial statements.

**NOTE 22 - FIRST RELIANCE BANCSHARES, INC. (PARENT COMPANY ONLY)**

Condensed Balance Sheets

	December 31,	
	2012	2011
Assets		
Cash	\$3,898,093	\$4,103,130
Investment in banking subsidiary	46,884,841	46,942,967
Marketable investments	5,500	11,000
Nonmarketable investments	58,100	58,100

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Land	3,959,268	3,959,268
Investment in trust	310,000	310,000
Other assets	11,859	3,648
<b>Total assets</b>	<b>\$55,127,661</b>	<b>\$55,388,113</b>
<b>Liabilities</b>		
Note payable to banking subsidiary	\$3,371,873	\$3,574,800
Junior subordinated debentures	10,310,000	10,310,000
Other liabilities	247,861	385,323
<b>Total liabilities</b>	<b>13,929,734</b>	<b>14,270,123</b>
Shareholders' equity	41,197,927	41,117,990
<b>Total liabilities and shareholders' equity</b>	<b>\$55,127,661</b>	<b>\$55,388,113</b>

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Condensed Statements of Operations

	For the years ended December 31,	
	2012	2011
Income		
Rental income from banking subsidiary	\$84,029	\$360,000
Other income (loss)	4	(93,314 )
Total Income	84,033	266,686
Expenses	129,239	522,848
Loss before income taxes and equity in undistributed loss of banking subsidiary	(45,206 )	(256,162 )
Equity in undistributed earnings (loss) of banking subsidiary	321,046	(8,625,030)
Net income (loss) before income taxes	275,840	(8,881,192)
Income tax expense	-	499,923
Net income (loss)	\$275,840	\$(9,381,115)

Condensed Statements of Cash Flows

	For the years ended December 31,	
	2012	2011
Cash flows from operating activities		
Net income (loss)	\$275,840	\$(9,381,115)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss on sale of investment securities	-	98,285
Amortization of deferred compensation on restricted stock	190,477	208,774
(Increase) decrease in other assets	(8,211 )	535,878
Decrease in other liabilities	(135,591 )	(78,163 )
Equity in undistributed (earnings) loss of banking subsidiary	(321,046 )	8,625,030
Net cash provided by operating activities	1,469	8,689
Cash flows from by investing activities		
Proceeds from sale of investment securities	-	1,715
Net cash provided by investing activities	-	1,715
Cash flows from financing activities		
Payments of note payable to banking subsidiary	(202,927 )	(196,363 )
Net proceeds from issuance of common stock	5,005	2,370
Preferred stock dividends	-	(747,743 )

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Purchase of treasury stock	(8,584 )	(4,786 )
Net cash used by financing activities	(206,506 )	(946,522 )
Decrease in cash	(205,037 )	(936,118 )
Cash and cash equivalents, beginning of year	4,103,130	5,039,248
Cash and cash equivalents, ending of year	\$3,898,093	\$4,103,130

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**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Disclosure Controls**

As of the end of the period covered by this Annual Report on Form 10-K, our principal executive officer and principal financial officer have evaluated the effectiveness of our “disclosure controls and procedures” (“Disclosure Controls”). Disclosure Controls, as defined in Rule 13a-15(e) of the Exchange Act, are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Exchange Act, such as this Annual Report, is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms. Disclosure Controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including the Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”) as appropriate to allow timely decisions regarding required disclosure.

Our management, including the CEO and CFO, does not expect that our Disclosure Controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based upon their controls evaluation, our CEO and CFO have concluded that our Disclosure Controls are effective at a reasonable assurance level.

## **Management's Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is a process designed to provide reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition, transactions are executed in accordance with appropriate management authorization and accounting records are reliable for the preparation of financial statements in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2012. Management based this assessment on criteria for effective internal control over financial reporting described in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management's assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of its internal control over financial reporting. Management reviewed the results of its assessment with the Audit Committee of our Board of Directors.

Based on this assessment, management believes that First Reliance Bancshares, Inc. maintained effective internal control over financial reporting as of December 31, 2012.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the SEC that permit the Company to provide only management's report in this annual report.

## **Changes to Internal Control Over Financial Reporting**

There have been no changes in our internal control over financial reporting during our fourth fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

Not Applicable.

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE**

The Company has adopted a Code of Ethics that applies to its principal executive, financial and accounting officers. The Code of Ethics has been posted to the Company's website at [www.firstreliance.com](http://www.firstreliance.com). A copy may also be obtained, without charge, upon written request addressed to First Reliance Bancshares, Inc., 2170 West Palmetto Street, Florence, South Carolina 29501, Attention: Corporate Secretary. The request may be delivered by letter to the address set forth above or by fax to the attention of the Company's Corporate Secretary at (843) 656-3045.

The remaining information for this Item is included in the Company's Proxy Statement for the Annual Meeting of Shareholders to be held on June 20, 2013, under the headings "Proposal No. 1: Election of Directors", "Security Ownership of Certain Beneficial Owners and Management," "Section 16(a) Beneficial Ownership Reporting Compliance" and "Corporate Governance" and are incorporated herein by reference.

**ITEM 11. EXECUTIVE COMPENSATION**

The responses to this Item are included in the Company's Proxy Statement for the Annual Meeting of Shareholders to be held on June 20, 2013, under the headings "Proposal: Election of Directors – Director Compensation" and "Executive Compensation" and are incorporated herein by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The following table provides information regarding compensation plans under which equity securities of the Company are authorized for issuance. All data is presented as of December 31, 2012.

## Equity Compensation Plan Table

Plan category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	-	-	-
Equity compensation plans not approved by security holders	180,212	\$4.09	677,918
Total	180,212	\$4.09	677,918

Based on current economic conditions, the board and management, on August 19, 2010, agreed to cancel all remaining non-qualified option grants that had been previously granted to six employees in exchange for issuance of 67,081 restricted stock grants to these same six employees. These grants do not vest until April 15, 2013.

On January 19, 2006, the Board of Directors approved the First Reliance Bancshares, Inc. 2006 Equity Incentive Plan (the "2006 Plan"). The 2006 Plan provides that the Company may grant stock incentives to participants in the form of nonqualified stock options, dividend equivalent rights, phantom shares, stock appreciation rights, stock awards, and performance unit awards (each a "Stock Incentive"). The Company reserved up to 350,000 shares of the Company's common stock for issuance pursuant to awards granted under the Plan. The 2006 Plan was amended in 2010 to increase the number of shares reserved for issuance there under to 950,000. This number of shares may change in the

event of future stock dividends, stock splits, recapitalizations and similar events. If a Stock Incentive expires or terminates without being paid, exercised or otherwise settled, the shares subject to that Stock Incentive may again be available for awards under the 2006 Plan.

The additional responses to this Item are included in the Company's Proxy Statement for the Annual Meeting of Shareholders to be held on June 20, 2013, under the heading "Security Ownership of Certain Beneficial Owners and Management" and are incorporated herein by reference.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The responses to this Item are included in the Company's Proxy Statement for the Annual Meeting of Shareholders to be held on June 20, 2013, under the headings "Related Party Transactions" and "Proposal: Election of Directors – Director Independence" and are incorporated herein by reference.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The responses to this Item are included in the Company Proxy Statement for the Annual Meeting of Shareholders to be held on June 20, 2013, under the heading “Audit Committee Matters – Independent Registered Public Accounting Firm” and are incorporated herein by reference.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

A list of exhibits included as part of this annual report is set forth in the Exhibit Index that immediately precedes the exhibits and is incorporated by reference herein.

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## SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the Registrant caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST RELIANCE BANCSHARES, INC.

By: /s/ F. R. Saunders, Jr.  
F. R. Saunders, Jr.  
President and Chief Executive Officer

Date: March 22, 2013

Pursuant to the requirements of the Securities and Exchange Act of 1934, the report has been signed by the following persons on behalf of the registrant and in the capacities indicated on March 22, 2013.

<b>Signature</b>	<b>Title</b>
/S/ F.R. Saunders, Jr. <b>F.R. Saunders, Jr.</b> <b>(Principal Executive Officer)</b>	Director, President and Chief Executive Officer
/S/ Jeffery A. Paolucci <b>Jeffrey A. Paolucci</b> <b>(Principal Financial and Accounting Officer)</b>	Director, Executive Vice President and Chief Financial Officer and Secretary
/S/ Leonard A. Hoogenboom <b>Leonard A. Hoogenboom</b>	Chairman of the Board
/S/ John M. Jebaily <b>John M. Jebaily</b>	Director
/S/ James R. Lingle, Jr. <b>James R. Lingle, Jr.</b>	Director
/S/ C. Dale Lusk <b>C. Dale Lusk</b>	Director
/S/ Julius G. Parris	Director

**Julius G. Parris**

/S/ A. Dale Porter  
**A. Dale Porter**

Director

/S/ Paul C. Saunders  
**Paul C. Saunders**

Director

/S/ J. Munford Scott  
**J. Munford Scott**

Director

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## EXHIBIT INDEX

Exhibit Number	Description
3.1	Amended and Restated Articles of Incorporation, as amended, of First Reliance Bancshares, Inc.
3.2	Articles of Amendment to the Articles of Incorporation authorizing a class of preferred stock. <sup>2</sup>
3.3	Articles of Amendment to the Articles of Incorporation establishing the terms of the Series A Preferred Stock and the Series B Preferred Stock. <sup>2</sup>
3.4	Articles of Amendment to the Articles of Incorporation establishing the terms of the Series C Preferred Stock. <sup>3</sup>
3.5	Bylaws of First Reliance Bancshares, Inc. <sup>4</sup>
4.1	See Articles of Incorporation, as amended at Exhibit 3.1, 3.2 and 3.3 hereto and Bylaws at Exhibit 3.5 hereto.
4.2	Indenture between the Registrant and the Trustee. <sup>5</sup>
4.3	Guarantee Agreement. <sup>5</sup>
4.4	Amended and Restated Declaration. <sup>5</sup>
4.5	Form of Certificate for the Series A Preferred Stock. <sup>2</sup>
4.6	Form of Certificate for the Series B Preferred Stock. <sup>2</sup>
4.7	Warrant to Purchase up to 767.00767 shares of Series B Preferred Stock, dated March 6, 2009. <sup>2</sup>
10.1*	1999 First Reliance Bank Employee Stock Option Plan. <sup>6</sup>
10.2*	Amendment No. 1 to the 1999 First Reliance Bank Employee Stock Option Plan. <sup>6</sup>
10.3*	Amendment No. 2 to the 1999 First Reliance Bank Employee Stock Option Plan. <sup>7</sup>
10.4*	First Reliance Bancshares, Inc. 2003 Stock Incentive Plan. <sup>8</sup>
10.5*	First Reliance Bancshares, Inc. 2006 Equity Incentive Plan. <sup>9</sup>
10.6	Lease Agreement between SP Financial, LLC and First Reliance Bank. <sup>9</sup>
10.7*	Employment Agreement with F. R. Saunders, Jr., dated November 24, 2006. <sup>10</sup>
10.8*	Salary Continuation Agreement with F. R. Saunders, Jr., dated November 24, 2006. <sup>10</sup>
10.9*	Endorsement Split Dollar Agreement with F. R. Saunders, Jr., dated November 24, 2006. <sup>10</sup>
10.10*	Amended Supplemental Life Insurance Agreement with F. R. Saunders, Jr., dated December 28, 2007. <sup>11</sup>
10.11*	Employment Agreement with Jeffrey A. Paolucci, dated November 24, 2006. <sup>10</sup>
10.12*	Salary Continuation Agreement with Jeffrey A. Paolucci, dated November 24, 2006. <sup>10</sup>
10.13*	Endorsement Split Dollar Agreement with Jeffrey A. Paolucci, dated November 24, 2006. <sup>10</sup>
10.14*	Employment Agreement with Paul Saunders, dated November 24, 2006. <sup>10</sup>
10.15*	Salary Continuation Agreement with Paul Saunders, dated November 24, 2006. <sup>10</sup>
10.16*	Endorsement Split Dollar Agreement with Paul Saunders, dated November 24, 2006. <sup>10</sup>
10.17*	Form of Director Retirement Agreement, with Schedule. <sup>10</sup>
10.18*	Amended and Restated Employment Agreement with Dale Porter. <sup>10</sup>

<sup>1</sup> Incorporated by reference to Quarterly Report on Form 10-Q, for the quarter ended June 30, 2010.

<sup>2</sup> Incorporated by reference to Current Report on Form 8-K, dated March 10, 2009.

<sup>3</sup> Incorporated by reference to Current Report on Form 8-K, dated May 28, 2010.

<sup>4</sup> Incorporated by reference to Annual Report on Form 10-K for the year ended December 31, 2011.

<sup>5</sup> Incorporated by reference to Current Report on Form 8-K, dated July 1, 2005.

<sup>6</sup> Incorporated by reference to Quarterly Report on Form 10-QSB, for the quarter ended March 31, 2002.

<sup>7</sup> Incorporated by reference to Quarterly Report on Form 10-QSB, for the quarter ended June 30, 2002.

<sup>8</sup> Incorporated by reference to Annual Report on Form 10-KSB for the year ended December 31, 2003.

<sup>9</sup> Incorporated by reference to Annual Report on Form 10-KSB for the year ended December 31, 2005.

<sup>10</sup> Incorporated by reference to Annual Report on Form 10-K for the year ended December 31, 2006.

<sup>11</sup> Incorporated by reference to Current Report on Form 8-K, dated December 28, 2007.

- 10.19\* Employment Agreement with Thomas C. Ewart, Sr. <sup>8</sup>
- 10.20 Letter Agreement, dated March 6, 2009, including Securities Purchase Agreement – Standard Terms, incorporated by reference therein, between the Company and the United States Department of the Treasury.<sup>2</sup>
- 10.21 Side Letter Agreement, dated March 6, 2009.<sup>2</sup>
- 10.22\* Form of Waiver.<sup>2</sup>
- 10.23\* Form of Senior Executive Officer Agreement.<sup>2</sup>
- 10.24\* 2010 Amendment to First Reliance Bancshares, Inc. 2006 Equity Incentive Plan. <sup>4</sup>
- 10.25\* 2012 Amendment to First Reliance Bancshares, Inc. 2006 Equity Incentive Plan. <sup>4</sup>
- 21.1 Subsidiaries of First Reliance Bancshares, Inc. <sup>9</sup>
- 23.1 Consent of Elliott Davis, LLC.
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15(d)-14(a).
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15(d)-14(a).
- 32.1 Certification of Chief Executive and Financial Officers pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1 Certification of Compliance with EESA Section 111 by Chief Executive Officer
- 99.2 Certification of Compliance with EESA Section 111 by Chief Financial Officer
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\*Indicates management contract or compensatory plan or arrangement.