

FIRST RELIANCE BANCSHARES INC
Form 10-K/A
April 02, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-K/A

**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, 2006

OR

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

For the transition period from _____ to _____

Commission File Number 000-49757

FIRST RELIANCE BANCSHARES, INC.

(Exact Name of Registrant as Specified in its Charter)

South Carolina
(State of Incorporation)

80-0030931
(I.R.S. Employer Identification No.)

2170 W. Palmetto Street, Florence, South Carolina
(Address of Principal Executive Offices)

29501
(Zip Code)

(843) 656-5000

(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:
None

Securities Registered Pursuant to Section 12(g) of the Act:
Common Stock, \$0.01 Par Value

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

YesNo

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.

Edgar Filing: FIRST RELIANCE BANCSHARES INC - Form 10-K/A

YesNo

x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities 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.

YesNo

x

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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YesNo

x

The aggregate market value of the registrant's outstanding common stock held by nonaffiliates of the registrant as of June 30, 2006, was approximately \$48.7 million, based on the registrant's closing sales price of \$16.68 as reported on the Over-the Counter Bulletin Board on June 30, 2006. There were 3,435,628 shares of the registrant's common stock outstanding as of March 1, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Document

Parts Into Which Incorporated

Annual Report to Shareholders for the Year Ended December 31, 2006
Proxy Statement for the Annual Meeting of Shareholders to be held June 21, 2007

Part II
Part III

EXPLANATORY NOTE

This Annual Report on Form 10-K is being refiled with the SEC to add the conformed signatures of the Principal Officers and the Board of Directors, to the Annual Report on Form 10-K previously filed on, March 30, 2007, as well as changes to update the Equity Compensation Plan Table in Item 12, a corrected cross-reference in Item 7A and a technical update to file the Company's Annual Report as an exhibit on the EDGAR system.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

Special Cautionary Notice Regarding Forward-Looking Statements

This Report contains statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and the Securities Exchange Act of 1934. Various matters discussed in this document and in documents incorporated by reference herein, including matters discussed under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations, may constitute forward-looking statements for purposes of the Securities Act and the Securities Exchange Act. These forward-looking statements are based on many assumptions and estimates and are not guarantees of future performance, and may involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of First Reliance Bancshares, Inc. (the

Company) or its wholly owned subsidiary, First Reliance Bank (the Bank), to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. The words expect, anticipate, intend, plan, believe, seek, similar expressions are intended to identify such forward-looking statements. The Company's and the Bank's actual results may differ materially from the results anticipated in these forward-looking statements due to a variety of factors, including, without limitation:

significant increases in competitive pressure in the banking and financial services industries;

changes in the interest rate environment that could reduce anticipated or actual margins;

changes in political conditions or the legislative or regulatory environment;

general economic conditions, either nationally or regionally and especially in our primary service area, becoming less favorable than expected resulting in, among other things, a deterioration in credit quality;

changes occurring in business conditions and inflation;

changes in technology;

changes in monetary and tax policies;

the level of allowance for loan loss;

the rate of delinquencies and amounts of charge-offs;

the rates of loan growth;

adverse changes in asset quality and resulting credit risk-related losses and expenses;

changes in the securities markets; and

other risks and uncertainties detailed from time to time in our filings with the Securities and Exchange Commission.

All written or oral forward-looking statements attributable to the Company are expressly qualified in their entirety by these cautionary statements.

General

The Company was incorporated under the laws of the State of South Carolina on April 12, 2001 to be the holding company for First Reliance Bank (the Bank), and 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 4 branch offices. The Bank serves the Florence, Lexington, and Charleston, South Carolina areas as an independent, community-oriented commercial bank emphasizing high-quality, responsive and personalized service. The Bank provides a broad range of consumer and commercial banking services, concentrating on individuals and small and medium-sized businesses desiring a high level of personalized services.

Marketing Focus

The Bank advertises aggressively, using popular forms of media and direct mail, to target market segments and emphasizes the Bank's substantial local ownership, community bank nature, locally oriented operations and ability to provide prompt, knowledgeable and personalized service.

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, 709 North Lake Drive, Lexington, South Carolina, 800 South Shelmore Blvd., Mount Pleasant, South Carolina and 51 Cumberland Street, Suite 101, Charleston, South Carolina. The Bank's primary market areas are the Cities of Florence, Lexington, and Charleston and the surrounding areas of Florence, Lexington, and Charleston Counties, South Carolina.

According to the South Carolina Department of Commerce, in 2000, Florence County had an estimated population of 125,761. 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, Wellman, Inc., Honda, Nan Ya Plastics, ESAB, McLeod Regional Medical Center, and Carolinas Medical Center, DuPont Teijin Films, Roche, Stone Container, S&W Manufacturing, GE Healthcare, and Nucor Steel. The principal components of the economy of Florence County are the wholesale and retail trade sector, the manufacturing sector, the services sector and the financial, insurance and real estate sector.

First Reliance Bank opened a branch office at 709 North Lake Drive, Lexington, South Carolina in 2004. Lexington County had an estimated population in 2003 of 226,528. 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, Lexington Medical Center, Lexington County School District, and Southeastern Freight, 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 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.

First Reliance Bank opened a branch office in Mount Pleasant, South Carolina as well a branch office in Charleston, South Carolina in 2005. Charleston County has a population of 309,969 and the Metro Area has a population of 549,033 according to the 2000 census. Charleston is located on the central and southern east coast surrounded by Berkley and Dorchester counties. Major employers in the area include US Navy, Medical University of South Carolina, and the Charleston Air Force Base.

Banking Services

The Bank strives to provide its customers with the breadth of products and services comparable to those offered by large regional banks, while maintaining the quick response and personal service of a locally owned and managed bank. In addition to offering a full range of deposit services and commercial and personal loans, the Bank offers investment services and products such as mortgage loan origination, wholesale mortgage services and title insurance services.

The Bank seeks to promote continuous long-term relationships. Because management of the Bank is located in Florence, Lexington, and Charleston South Carolina, all credit and related decisions are made locally, which facilitates prompt responses by persons familiar with the borrower's local business environment.

Edgar Filing: FIRST RELIANCE BANCSHARES INC - Form 10-K/A

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 daily 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. The Bank also offers free courier service for business accounts. All deposit accounts are insured by the FDIC up to the maximum amount allowed by law. The Bank solicits these accounts from individuals, businesses, associations and organizations and governmental authorities.

Loan Products. The Bank offers a full range of commercial and consumer loans, as well as real estate, construction and acquisition 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 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.

As of December 31, 2006, the classification of the commercial loans of the Bank and the respective percentage of the Bank's total loan portfolio of each are as follows:

Description	Total Outstanding as of December 31, 2006	Percentage of Total Loan Portfolio
Loans to finance agricultural production and other farm loans	\$	%
Commercial and industrial loans	\$ 51,710	14%

Commercial loans involve significant risk because there is generally a small market available for an asset held as collateral that needs to be liquidated. Commercial loans for working capital needs are typically difficult to monitor.

As of December 31, 2006, the classification of the consumer loans of the Bank and the respective percentage of the Bank's total loan portfolio of each are as follows:

Description	Total Outstanding as of December 31, 2006	Percentage of Total Loan Portfolio
Individuals (household, personal, single pay, installment and other)	\$ 11,129	3%
Individuals (household, family, personal credit cards and overdraft protection)	\$ 1,599	1%
All other consumer loans	\$ 7,014	2%

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

Edgar Filing: FIRST RELIANCE BANCSHARES INC - Form 10-K/A

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 10% of the Bank's unimpaired capital, except that by two-thirds vote of the directors of the Bank such limit may be increased to 15% of the Bank's unimpaired capital. The Bank's Board of Directors has approved that increase in its lending limit. Based on the Bank's unimpaired capital as of December 31, 2006, the Bank's lending limit to a single customer is approximately \$6.97 million. Even with the increase, 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.

Mortgage Loan Division. 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, 2006, 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, 2006	Percentage of Total Loan Portfolio
Secured by non-farm, non-residential properties	\$ 123,689	34%
Construction and land development	\$ 64,118	18%
Farmland (including farm residential and other improvements)	\$ 3,525	1%
Revolving, open end loans secured by 1-4 family extended under line of credit	\$ 27,853	8%
All other loans secured by 1-4 family residential (1st lien)	\$ 57,477	16%
All other loans secured by 1-4 family residential (junior lien)	\$ 4,513	1%
Secured by multi-family (5 or more) residential properties - condos and apartments	\$ 7,827	2%

Of the loan types listed above, commercial real estate loans are generally more risky because they are the most difficult to liquidate. Construction loans also involve risks due to weather delays and cost overruns.

Edgar Filing: FIRST RELIANCE BANCSHARES INC - Form 10-K/A

The Bank generates additional fee income by selling most of its mortgage loans in the secondary market and cross-selling its other products and services to its mortgage customers. In 2006, the Bank sold mortgage loans in a total amount of approximately \$136,914,999 or 37.50% of the total number of mortgage loans originated by the Bank.

All FHA, VA and 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 4 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 2006, of the 935 loans sold by the Bank, 10 were FHA or VA loans and 29 were State Housing loans. Such loans represented 7.4% of the dollar volume or 4.17% of the total number of loans sold by the Bank in 2006.

In addition, an increase in interest rates may decrease the demand for consumer and commercial credit, including real estate loans. Net fees from residential mortgage originations were \$1.6 million, or 4.39%, of our gross revenue in 2006. We expect to originate more real estate loans in 2007 with the addition of more mortgage originators. Accordingly, a period of rising interest rates could negatively affect our residential mortgage origination business.

Other Banking Services. First Reliance 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, and personal mortgage loans, while business products include checking and savings accounts, commercial lending services, money market accounts, and business deposit courier service. In September 2004, the Company began offering Wholesale Mortgage Services and Title Insurance Services. In December 2004, the Company began offering business customers a courier service. The Company also provides Internet banking, electronic bill paying services, free ATMs, and an overdraft privilege to its customers. 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 <http://firstreliance.com>.

First Reliance's growth has been excellent and has been driven by expansion into new markets as well as organic growth. Further, much of that growth has come in low or no cost deposit accounts, which leverages the investment the Bank has made in customer service initiatives and provides a low cost of funds for the Bank. Two of the initiatives the Bank has implemented to achieve its strong growth are extended hours and an incentive plan that rewards employees at the customer contact level. The extended hours initiative, known as First Reliance's 8 to 8 program, continues to receive positive responses from customers, and the Company's goal is to eventually have an 8 to 8 operation for each of the geographic regions in which it operates. Management attributes part of the rapid growth in core deposits to the recent introduction of its Balanced Scorecard, which focuses on driving profitability, growth and improving efficiencies. During the quarter, its customers rewarded the Bank with a 94% customer satisfaction rating.

First Reliance's strong balance sheet growth led it to be recognized as one of South Carolina's Top 25 Fastest Growing Companies by Elliott Davis, LLC, in association with the SC Chamber of Commerce. The most recent award is the fourth time First Reliance has received this distinction, and it is the only SC bank to receive this honor this many times. Over the past year, (from December 31, 2005 to December 31, 2006), total assets increased 13%, net loans (excluding loans held for sale) grew 12% and deposits were up 12%.

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 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 \$100,000. 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. Our asset and liability management committee reviews the investment portfolio on an ongoing basis to ascertain investment profitability and to verify compliance with the Bank's investment policies.

Other Services. In addition to its banking services, the Bank offers securities brokerage services and life insurance products to its customers through a financial services division of the Bank. The Bank obtained an insurance agency license under South Carolina law to sell life insurance and has relationships with brokers and carriers. The Bank's financial services division uses professional money managers who diversify a client's portfolio into several different asset classes. Some of the products offered are mutual funds, annuities, stocks, bonds, insurance, IRAs and 401(k) rollovers.

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 branch networks. In addition, subject to certain conditions, South Carolina 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.

As of June 30, 2006, 28 banks and five savings institutions operated 224 offices within Charleston, Florence and Lexington Counties. All of these institutions aggressively compete for business in the Bank's market area. Most of these competitors have been in business for many years, have established customer bases, are substantially 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 five branches in Charleston, Florence and Lexington Counties, South Carolina. Based upon data available on the FDIC website as of June 30, 2006, the Bank's total deposits ranked 8 among financial institutions in our market area, representing approximately 4.6% of the total deposits in our market area. The table below shows our deposit market share in the counties we serve according to data from the FDIC website as of June 30, 2006.

Market	Number of Branches	Our Market Deposits	Total Market Deposits	Ranking	Market Share Percentage (%)
(Dollar amounts in millions)					
South Carolina					
Charleston County	2	\$ 67	\$ 6,472	13	1.0%
Florence County	2	223	1,963	3	11.3
Lexington County	1	65	2,345	8	3.0
First Reliance Bank	5	\$ 355	\$ 10,781	8	3.3%

The Bank attempts to compete by 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 also attempts to offer a wide variety of financial products and services at fees that are competitive with other financial institutions.

Employees

On December 31, 2006, the Bank had 129 full-time employees and 16 part-time employee. The executive officers of the Company are the only officers of the Company, but they receive no compensation from the Company. The Company has no employees.

Supervision and Regulation

Both the Company and the Bank are subject to extensive state and federal banking regulations that impose restrictions on and provide for general regulatory oversight of their operations. These laws generally are intended to protect depositors and not shareholders. The following discussion describes the material elements of the regulatory framework that applies to us.

First Reliance Bancshares, Inc.

Since the Company owns all of the capital stock of the Bank, it is a bank holding company under the federal Bank Holding Company Act of 1956. As a result, the Company is primarily subject to the supervision, examination, and reporting requirements of the Bank Holding Company Act and the regulations of the Federal Reserve.

Acquisitions of Banks. The Bank Holding Company Act requires every bank holding company to obtain the Federal Reserve's prior approval 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, 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. 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. As a result, no bank holding company may acquire control of the Company until after the fifth anniversary date of the Bank's incorporation. Because the Bank has not been incorporated for more than five years, this restriction would not limit our ability to sell.

Additionally, In July 1994, South Carolina enacted legislation which effectively provided that, after June 30, 1996, out-of-state bank holding companies may acquire other banks or bank holding companies in South Carolina, subject to certain conditions. Accordingly, effective July 1, 1996, South Carolina law was amended to permit interstate branching but not de novo branching by an out-of-state bank. The Company believes that the foregoing legislation has increased takeover activity of South Carolina financial institutions by out-of-state financial institutions.

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:

Edgar Filing: FIRST RELIANCE BANCSHARES INC - Form 10-K/A

the bank holding company has registered securities under Section 12 of the Securities Exchange 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 any rebuttable presumption of control.

Permitted Activities. A bank holding company is generally permitted under the Bank Holding Company Act, to engage in or acquire direct or indirect control of more than 5% of the voting shares of any company engaged in the following activities:

banking or managing or controlling banks; and

any activity that the Federal Reserve determines to be so closely related to banking as to be a proper incident to the business of banking.

Activities that the Federal Reserve has found to be so closely related to banking as to be a proper incident to the business of banking include:

factoring accounts receivable;

making, acquiring, brokering or servicing loans and usual related activities;

leasing personal or real property;

operating a non-bank depository institution, such as a savings association;

trust company functions;

financial and investment advisory activities;

conducting discount securities brokerage activities;

underwriting and dealing in government obligations and money market instruments;

providing specified management consulting and counseling activities;

performing selected data processing services and support services;

acting as agent or broker in selling credit life insurance and other types of insurance in connection with credit transactions; and

performing selected insurance underwriting activities.

Despite prior approval, the Federal Reserve may order a bank holding company or its subsidiaries to terminate any of these activities or to terminate its ownership or control of any subsidiary when it has reasonable cause to believe that the bank holding company's continued ownership, activity or control constitutes a serious risk to the financial safety, soundness, or stability of it or any of its bank subsidiaries.

In addition to the permissible bank holding company activities listed above, the Financial Services Modernization Act of 1999, or the Gramm-Leach-Bliley Act, revised and expanded the provisions of the Bank Holding Company Act by permitting a bank holding company to qualify and elect to become 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 activity. The following activities are considered financial in nature:

lending, trust and other banking activities;

insuring, guaranteeing, or indemnifying against loss or harm, or providing and issuing annuities, and acting as principal, agent, or broker for these purposes, in any state;

providing financial, investment, or advisory services;

Edgar Filing: FIRST RELIANCE BANCSHARES INC - Form 10-K/A

issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;

underwriting, dealing in or making a market in securities;

other activities that the Federal Reserve may determine to be so closely related to banking or managing or controlling banks as to be a proper incident to managing or controlling banks;

foreign activities permitted outside of the United States if the Federal Reserve has determined them to be usual in connection with banking operations abroad;

merchant banking through securities or insurance affiliates; and

insurance company portfolio investments.

On December 18, 2006, the SEC and the Federal Reserve issued joint proposed rules, which would implement the broker exception for banks under Section 3(a)(4) of the Exchange Act of 1934 and would be adopted as part of the Gramm-Leach-Bliley Act. The proposed rules would implement the statutory exceptions that allow a bank, subject to certain conditions, to continue to conduct securities transactions for the Bank's customers as part of its trust and fiduciary, custodial and deposit sweep functions, and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer.

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, the Company is expected to act as a source of financial strength for the Bank and to commit resources to support the Bank. This support may be required at times when, without this Federal Reserve policy, the Company might not be inclined to provide it. In addition, any capital loans made by the Company to the Bank will be repaid only after its deposits and various other obligations are repaid in full. In the unlikely event of the Company's bankruptcy, any commitment by it to a federal 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 South Carolina State Board of Financial Institutions (the State Board). The Company must receive the approval of the 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 State Board periodic reports with respect to its financial condition, operations and management, and the intercompany relationships between the Company and its subsidiaries.

First Reliance Bank

The Bank is a state chartered bank insured by the FDIC and not a member of the Federal Reserve. As such, the Bank is subject to supervision and regulation by the FDIC and the State Board. Supervision, regulation and examination of banks by regulatory agencies are intended primarily for the protection of depositors rather than stockholders of the banks.

South Carolina Law. Commercial banks chartered in South Carolina have only those powers granted by law or the regulations of the State Board. State law sets specific requirements for bank capital and regulates deposits in and loans and investments by banks, including the amounts, types and, in some cases, rates. In addition, the State Board regulates, among other activities, the payment of dividends, the opening of branches, loans to officers and directors, record keeping and the use of automated teller machines. The State Board periodically examines state banks to determine their compliance with the law and regulations, and state banks must make periodic reports of their condition to the State Board.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991 establishes a system of prompt corrective action to resolve the problems of undercapitalized financial institutions. Under this system, the federal banking regulators have established five capital categories (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) in which all institutions are placed. Federal banking regulators are required to take various mandatory supervisory actions and are authorized to take other discretionary actions with respect to institutions in the three undercapitalized categories. The severity of the action depends upon the capital category in which the institution is placed. Generally, subject to a narrow exception, the banking regulator must appoint a receiver or conservator for an institution that is critically undercapitalized. The federal banking agencies have specified by regulation the relevant capital level for each category.

An institution that is categorized as undercapitalized, significantly undercapitalized, or critically undercapitalized is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. A bank holding company must guarantee that a subsidiary depository institution meets its capital restoration plan, subject to various limitations. The controlling holding company's obligation to fund a capital restoration plan is limited to the lesser of 5% of an undercapitalized subsidiary's assets at the time it became undercapitalized or the amount required to meet regulatory capital requirements. An undercapitalized institution is also generally prohibited from increasing its average total assets, making acquisitions, establishing any branches or engaging in any new line of business, except under an accepted capital restoration plan or with FDIC approval. The regulations also establish procedures for downgrading an institution to a lower capital category based on supervisory factors other than capital.

FDIC Insurance Assessments. The FDIC has adopted a risk-based assessment system for insured depository institutions that takes into account the risks attributable to different categories and concentrations of assets and liabilities. The system assesses higher rates on those institutions that pose greater risks to the Deposit Insurance Fund. The FDIC places each institution in one of four risk categories using a two-step process based first on capital ratios (the capital group assignment) and then on other relevant information (the supervisory group assignment). Within the lower risk category, Risk Category I, rates will vary based on each institution's CAMELS component ratings, certain financial ratios, and long-term debt issuer ratings.

Capital group assignments are made quarterly and an institution is assigned to one of three capital categories: (1) well capitalized; (2) adequately capitalized; and (3) undercapitalized. These three categories are substantially similar to the prompt corrective action categories described above, with the undercapitalized category including institutions that are undercapitalized, significantly undercapitalized, and critically undercapitalized for prompt corrective action purposes. The FDIC also assigns an institution to one of three supervisory subgroups based on a supervisory evaluation that the institution's primary federal regulator provides to the FDIC and information that the FDIC determines to be relevant to the institution's financial condition and the risk posed to the deposit insurance funds. Assessments range from 5 to 43 cents per \$100 of deposits, depending on the institution's capital group and supervisory subgroup. Institutions that are well capitalized will be charged a rate between 5 and 7 cents per \$100 of deposits.

In addition, the FDIC imposes assessments to help pay off the \$780 million in annual interest payments on the \$8 billion Financing Corporation bonds issued in the late 1980s as part of the government rescue of the thrift industry. This assessment rate is adjusted quarterly and is set at 1.22 cents per \$100 of deposits for the first quarter of 2007.

The FDIC may terminate its insurance of deposits if it finds that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, or condition imposed by the FDIC.

Community Reinvestment Act. The Community Reinvestment Act requires that, in connection with examinations of financial institutions within their respective jurisdictions, the federal bank regulators shall evaluate the record of each financial institution in meeting the credit needs of its local community, including low and moderate-income neighborhoods. These facts are also considered in evaluating mergers, acquisitions and applications to open a branch or facility. Failure to adequately meet these criteria could impose additional requirements and limitations on the Bank. Since our aggregate assets are not more than \$250 million, under the Gramm-Leach-Bliley Act, we are generally subject to a Community Reinvestment Act examination only once every 60 months if we receive an outstanding rating, once every 48 months if we receive a satisfactory rating and as needed if our rating is less than satisfactory. Additionally, the Bank must publicly disclose the terms of various Community Reinvestment Act-related agreements.

Allowance for Loan 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 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 collectibility 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 nonfarm, 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 and 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 during the prior 36 months.

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.

The Bank's loan operations are also subject to federal laws applicable to credit transactions, such as the:

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 cred