FIRST RELIANCE BANCSHARES INC
Form 10-K
March 30, 2007

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)
ý **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

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

For the transition period from ________________to ________________

Commission File Number 000-49757

FIRST RELIANCE BANCSHARES, INC.
(Exact Name of Registrant as Specified in its Charter)

South Carolina	**80-0030931**
(State of Incorporation)	*(I.R.S. Employer Identification No.)*
2170 W. Palmetto Street, Florence, South Carolina	**29501**
(Address of Principal Executive Offices)	*(Zip Code)*

(843) 656-5000
(Registrant s telephone number, including area code)

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

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

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

Yes	No
o	x

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.

YesNo
o 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 o

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. o

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 o Accelerated filer o Non-accelerated filer ý

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

YesNo
o 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	Part II
Proxy Statement for the Annual Meeting of Shareholders to be held June 21, 2007	Part III

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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, estima 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.

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.

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.

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:

- 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;

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 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 depends; and

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

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

Truth-in-Savings Act, requiring certain disclosures for 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; and

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

Capital Adequacy

The Company and the Bank are required to comply with the capital adequacy standards established by the Federal Reserve, in the case of the Company, and the FDIC, in the case of the Bank. The Federal Reserve has established a risk-based and a leverage measure of capital adequacy for bank holding companies. Since the Company s consolidated total assets are less than $500 million, under the Federal Reserve s capital guidelines, our capital adequacy is measured on a bank-only basis, as opposed to a consolidated basis. The Bank is also subject to risk-based and leverage capital requirements adopted by the FDIC, which are substantially similar to those adopted by the Federal Reserve for bank holding companies.

The risk-based capital standards are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance-sheet exposure, and to minimize disincentives for holding liquid assets. Assets and off-balance-sheet items, such as letters of credit and unfunded loan commitments, are assigned to broad risk categories, each with appropriate risk weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance-sheet items.

The minimum guideline for the ratio of total capital to risk-weighted assets is 8%. Total capital consists of two components, Tier 1 Capital and Tier 2 Capital. Tier 1 Capital generally consists of common stock, minority interests in the equity accounts of consolidated subsidiaries, noncumulative perpetual preferred stock, and a limited amount of qualifying cumulative perpetual preferred stock, less goodwill and other specified intangible assets. Tier 1 Capital must equal at least 4% of risk-weighted assets. Tier 2 Capital generally consists of subordinated debt, other preferred stock, and a limited amount of loan loss reserves. The total amount of Tier 2 Capital is limited to 100% of Tier 1 Capital. At December 31, 2006, our ratio of total capital to risk-weighted assets was 12.45% and our ratio of Tier 1 Capital to risk-weighted assets was 11.42%.

In addition, the Federal Reserve has established minimum leverage ratio guidelines for bank holding companies. These guidelines provide for a minimum ratio of Tier 1 Capital to average assets, less goodwill and other specified intangible assets, of 3% for bank holding companies that meet specified criteria, including having the highest regulatory rating and implementing the Federal Reserve s risk-based capital measure for market risk. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2006, our leverage ratio was 9.90%. The guidelines also provide that bank holding companies experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels without reliance on intangible assets. The Federal Reserve considers the leverage ratio and other indicators of capital strength in evaluating proposals for expansion or new activities.

Failure to meet capital guidelines could subject a bank or bank holding company to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting brokered deposits, and certain other restrictions on its business. As described above, significant additional restrictions can be imposed on FDIC-insured depository institutions that fail to meet applicable capital requirements.

Payment of Dividends

The Company is a legal entity separate and distinct from the Bank. The principal sources of the Company s cash flow, including cash flow to pay dividends to its shareholders, are dividends that the Bank pays to its sole shareholder, the Company. Statutory and regulatory limitations apply to the Bank s payment of dividends to the Company as well as to the Company s payment of dividends to its shareholders.

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 State Board, provided that the Bank received a 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 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 Company and 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 were 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 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.

Restrictions on Transactions with Affiliates

The Company and the Bank are subject to the provisions of Section 23A of the Federal Reserve Act. Section 23A places limits on the amount of:

- a bank s loans or extensions of credit to affiliates;
- a bank s investment in affiliates;
- assets a bank may purchase from affiliates, except for real and personal property exempted by the Federal Reserve;
- loans or extensions of credit to third parties collateralized by the securities or obligations of affiliates; and
- a bank s guarantee, acceptance or letter of credit issued on behalf of an affiliate.

The total amount of the above transactions is 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 limitation on the amount of these transactions, each of the above transactions must also meet specified collateral requirements. The Bank must also comply with other provisions designed to avoid the taking of low-quality assets.

The Company and the Bank are also subject to the provisions of Section 23B of the Federal Reserve Act which, among other things, prohibit an institution from engaging in the above transactions with affiliates unless the transactions are on terms substantially the same, or at least as favorable to the institution or its subsidiaries, as those prevailing at the time for comparable transactions with nonaffiliated companies.

The Bank is also subject to restrictions on extensions of credit to its executive officers, directors, principal shareholders and their related interests. These extensions of credit (1) must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third parties, and (2) must not involve more than the normal risk of repayment or present other unfavorable features.

Privacy

Financial institutions are required to disclose their policies for collecting and protecting confidential information. Customers generally may prevent financial institutions from sharing nonpublic personal financial information with nonaffiliated third parties except under narrow circumstances, such as the processing of transactions requested by the consumer or when the financial institution is jointly sponsoring a product or service with a nonaffiliated third party. Additionally, financial institutions generally may not disclose consumer account numbers to any nonaffiliated third party for use in telemarketing, direct mail marketing or other marketing to consumers.

Anti-Terrorism and Money Laundering Legislation

The Bank is subject to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA PATRIOT Act), the Bank Secrecy Act, and rules and regulations of the Office of Foreign Assets Control. These statutes and related rules and regulations impose requirements and limitations on specified financial transactions and account relationships, intended to guard against money laundering and terrorism financing. The Bank has established a customer identification program pursuant to Section 326 of the USA PATRIOT Act and the Bank Secrecy Act, and otherwise have implemented policies and procedures to comply with the foregoing rules.

Federal Deposit Insurance Reform

On February 8, 2006, President Bush signed the Federal Deposit Insurance Reform Act of 2005 (the FDIRA).

Among other things, FDIRA changes the Federal deposit insurance system by:

- raising the coverage level for qualifying retirement accounts to $250,000, subject to future indexing;
- authorizing the FDIC and the National Credit Union Administration to index deposit insurance coverage for inflation for standard accounts and qualifying retirement accounts every five years beginning April 1, 2007;
- prohibiting undercapitalized financial institutions from accepting employee benefit plan deposits;
- merging the Bank Insurance Fund and Savings Association Insurance Fund into a new Deposit Insurance Fund; and
- providing credits to financial institutions that capitalized the FDIC prior to 1996 to offset future assessment premiums.

FDIRA also authorizes the FDIC to revise the current risk-based assessment system, subject to notice and comment and caps the amount of the Deposit Insurance Fund at 1.50% of domestic deposits. The FDIC must issue cash dividends, awarded on a historical basis, for the amount of the Deposit Insurance Fund over the 1.50% ratio. Additionally, if the Deposit Insurance Fund exceeds 1.35% of domestic deposits at year-end, the FDIC must issue cash dividends, awarded on a historical basis, for half of the amount of the excess.

Financial Services Regulatory Relief Act

President Bush signed the Financial Services Regulatory Relief Act of 2006 (Regulatory Relief Act) into law on October 13, 2006. The Regulatory Relief Act repeals certain reporting requirements regarding loans to bank executive officers and principal shareholders. These changes have eliminated the statutory requirements for (1) the report to the Board of Directors when an executive officer becomes indebted to another institution in an aggregate amount that is greater than the officer would receive from his or her own institution; (2) the report filed by the institution that listed all credits made to executive officers since the previous report of condition; and (3) the report to the Board of Directors that is required when an executive officer or a principal shareholder become indebted to a correspondence bank.

The Regulatory Relief Act increased the size of a bank eligible for 18-month (rather than annual) examinations from $250 million to $500 million. The Regulatory Relief Act amends the privacy rules of Gramm-Leach-Bliley to clarify that CPA s are not required to notify their customers of privacy and disclosure policies as long as they are subject to state law restraints on disclosure of non-public personal information without customer approval. Finally, the Regulatory Relief Act requires that the federal banking regulators develop model privacy notice forms, and banks adopting the model forms will be afforded a regulatory safe harbor under the disclosure requirements of Gramm-Leach-Bliley.

Proposed Legislation and Regulatory Action

New regulations and statutes are regularly proposed that contain wide-ranging changes to 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

Our earnings are affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies. The Federal Reserve Bank 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 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. We cannot predict the nature or impact of future changes in monetary and fiscal policies.

In addition to the federal and state laws noted above, South Carolina adopted, effective January 1, 2004, laws imposing restrictions and procedural requirements on mortgage loans classified as high-cost home loans and on the flipping of consumer home loans. As drafted, these laws generally apply to most mortgage loans made in South Carolina. The Bank has implemented procedures necessary to comply with these new laws.

Selected Statistical Information

The selected statistical information required by Item 1 is included in the Company s 2004 Annual Report to Shareholders, which is Exhibit 13.1 to this Report, under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations and is incorporated herein by reference.

ITEM 1A. RISK FACTORS

An investment in our common stock 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 occur, our business, financial condition and results of operations could be harmed. In such a case, the trading price of our common stock 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.

Our business strategy includes the continuation of significant growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.

We intend to continue pursuing a significant growth strategy for our business. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in significant growth stages of development. We cannot assure you we will be able to expand our market presence in our existing markets or successfully enter new markets or that any such expansion will not adversely affect our results of operations. Failure to manage our growth effectively could have a material adverse effect on our business, future prospects, financial condition or results of operations, and could adversely affect our ability to successfully implement our business strategy. Also, if our growth occurs more slowly than anticipated or declines, our operating results could be materially adversely affected.

Our ability to successfully grow will depend on a variety of factors including the continued availability of desirable business opportunities, the competitive responses from other financial institutions in our market areas and our ability to manage our growth. While we believe we have the management resources and internal systems in place to successfully manage our future growth, there can be no assurance growth opportunities will be available or growth will be successfully managed.

Changes in the interest rate environment could reduce our profitability.

Our profitability depends substantially upon our net interest income. Net interest income is the difference between the interest earned on assets, such as loans and investment securities, and the interest paid for liabilities, such as savings and time deposits. Market interest rates for loans, investments and deposits are highly sensitive to many factors beyond our control. Recently, interest rate spreads have generally narrowed due to changing market conditions, policies of various government and regulatory authorities and competitive pricing pressures, and we cannot predict whether these rate spreads will narrow even further. This narrowing of interest rate spreads could adversely affect our earnings and financial condition. 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 could suffer loan losses from a decline in credit quality.

We could sustain losses if borrowers, guarantors and related parties fail to perform in accordance with the terms of their loans. We have adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for credit losses, that we believe are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan performance and diversifying our credit portfolio. These policies and procedures, however, may not prevent unexpected losses that could materially adversely affect our results of operations.

We are subject to the local economies in Charleston, Florence and Lexington Counties, South Carolina..

Our success depends upon the growth in population, income levels, deposits and housing starts in our primary market areas. If the communities in which First Reliance Bank operate do not grow, or if prevailing economic conditions locally or nationally are unfavorable, our business may not succeed. Unpredictable economic conditions may have an adverse effect on the quality of our loan portfolio and our financial performance. Economic recession over a prolonged period or other economic problems in our market areas could have a material adverse impact on the quality of the loan portfolio and the demand for our products and services. Future adverse changes in the economies in our market areas may have a material adverse effect on our financial condition, results of operations or cash flows. Further, the banking industry in South Carolina is affected by general economic conditions such as inflation, recession, unemployment and other factors beyond our control. As a community bank, we are less able to spread the risk of unfavorable local economic conditions than larger or more regional banks. Moreover, we cannot give any assurance that we will benefit from any market growth or favorable economic conditions in our primary market areas if they do occur.

Our continued pace of growth may require us to raise additional capital in the future, but that capital may not be available when it is needed.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. We anticipate our capital resources following this offering will satisfy our capital requirements for the foreseeable future. We may at some point, however, need to raise additional capital to support our continued growth.

Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital if needed on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired.

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, which operate in our primary market areas and elsewhere.

We compete with these institutions both in attracting deposits and in making loans. 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 and 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.

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.

If the value of real estate in our core market were to decline materially, a significant portion of our loan portfolio could become under-collateralized, which could have a material adverse effect on us.

With most of our loans concentrated in Florence, Lexington, and Charleston South Carolina, a decline in local economic conditions could adversely affect the values of our real estate collateral. Consequently, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose real estate loan portfolios are geographically diverse.

In addition to considering the financial strength and cash flow characteristics of borrowers, we often secure loans with real estate collateral. At December 31, 2006, approximately 79.88% of our loans had real estate as a primary or secondary component of collateral. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, our earnings and capital could be adversely affected.

We face risks with respect to future expansion and acquisitions or mergers.

We continually seek to acquire other financial institutions or parts of those institutions and may continue to engage in de novo branch expansion in the future. Acquisitions and mergers involve a number of risks, including:

- the time and costs associated with identifying and evaluating potential acquisitions and merger partners may negatively affect our business;
- the estimates and judgments used to evaluate credit, operations, management and market risks with respect to the target institution may not be accurate;
- the time and costs of evaluating new markets, hiring experienced local management and opening new offices and the time lags between these activities and the generation of sufficient assets and deposits to support the costs of the expansion may negatively affect our business;
- we may not be able to finance an acquisition without diluting our existing shareholders;
- the diversion of our management s attention to the negotiation of a transaction may detract from their business productivity;
- we may enter into new markets where we lack experience;
- we may introduce new products and services into our business with which we have no prior experience; and
- we may incur an impairment of goodwill associated with an acquisition and experience adverse short-term effects on our results of operations.

In addition, no assurance can be given that we will be able to integrate our operations after an acquisition without encountering difficulties including, without limitation, the loss of key employees and customers, the disruption of our respective ongoing businesses or possible inconsistencies in standards, controls, procedures and policies. Successful integration of our operations with another entity s will depend primarily on our ability to consolidate operations, systems and procedures and to eliminate redundancies and costs. If we have difficulties with the integration, we might not achieve the economic benefits we expect to result from any particular acquisition or merger. In addition, we may experience greater than expected costs or difficulties relating to such integration.

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 Charleston County market area consists primarily of 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 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 recent results may not be indicative of our future results.

We may not be able to sustain our historical rate of growth or may not even be able to grow our business at all. In addition, our recent and rapid growth may distort some of our historical financial ratios and statistics. In the future, we may not have the benefit of several recently 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 experience a significant decrease in our historical rate of growth, our results of operations and financial condition may be adversely affected due to a high percentage of our operating costs being fixed expenses.

Lack of seasoning of our loan portfolio may increase the risk of credit defaults in the future.

Due to the rapid growth of the Bank over the past several years, a large portion of the loans in our loan portfolio and our lending relationships are of relatively recent origin. In general, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process we refer to as seasoning. As a result, a portfolio of older loans will usually behave more predictably than a newer loan portfolio. Because of the growth of our loan portfolio over the last two years, a significant portion of our loan portfolio is relatively new, and the current level of delinquencies and defaults may not be representative of the level that will prevail when the portfolio becomes more seasoned. If delinquencies and defaults increase, we may be required to increase our provision for loan losses, which would adversely affect our results of operations and financial condition.

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, 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 extensive regulation that could limit or restrict our activities and impose financial requirements or limitations on the conduct of our business.

As a bank holding company, we are primarily regulated by the Federal Reserve. Our subsidiary is primarily regulated by the State Board and the FDIC. Our compliance with Federal Reserve, State Board and FDIC regulations is costly and may limit our growth and restrict certain of our activities, including payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices. We are also subject to capital requirements of our regulators.

The laws and regulations applicable to the banking industry could change at any time, 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 Sarbanes-Oxley Act of 2002 and the related rules and regulations promulgated by the Securities and Exchange Commission, have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices. As a result, we may experience greater compliance costs.

Changes in monetary policies may have an adverse effect on our business.

Our 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.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not Applicable.

ITEM 2. DESCRIPTION OF PROPERTIES

The executive and main offices of the Company and the Bank are located at 2170 W. 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 will serve 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 branch at 709 North Lake Drive in Lexington, South Carolina. The Lexington branch facility, which is owned by the Bank, is located on approximately one acre of land and contains approximately 2,000 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 development of a future headquarters location.

On October 3, 2005, the Bank opened a branch at 800 South Shelmore Blvd., Mount Pleasant, South Carolina. The land is owned by the Bank.

On December 15,2005, the Bank purchased approximately 1.72 acres at 2031 Sam Rittenberg Blvd., Charleston, South Carolina for future branch expansion.

On February 1, 2006, the bank leased a mortgage office at 3790 Fernandia Road, Columbia, South Carolina

On February 9, 2006, the Bank purchased approximately 0.75 acres at 2148 West Palmetto Street, Florence, South Carolina for a future training facility.

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. Description of 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. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

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 2007 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 response to this Item 6 is included in the Company s 2007 Annual Report to Shareholders under the heading, Selected Financial Data and is incorporated herein by reference.

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

The response to this Item is included in the Company s 2007 Annual Report to Shareholders under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations and is incorporated herein by reference.

ITEM 7A. QUANTITATIVE AND QUALITIATIVE DISCLOSURES ABOUT MARKET RISK

The response to this Item 7 is included in the Company s 2007 Annual Report to Shareholders under the heading, Quantitative and Qualitative Disclosures About Market Risk Interest Sensitivity Analysis and is incorporated herein by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following financial statements are included in the Company s 2007 Annual Report to Shareholders, and are incorporated herein by reference:

Report of Independent Registered Public Accounting Firm

Financial Statements:

1. Consolidated Balance Sheets dated as of December 31, 2006 and 2005.
2. Consolidated Statements of Income for the Years Ended December 31, 2006, 2005 and 2004.
3. Consolidated Statements of Changes in Shareholders Equity and Comprehensive Income for the Years Ended December 31, 2006, 2005 and 2004.
4. Consolidated Statements of Cash Flows for the Years Ended December 31, 2006, 2005 and 2004.
5. Notes to Consolidated Financial Statements.

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

Not Applicable

ITEM 9A. CONTROLS AND PROCEDURES

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 Securities Exchange Act of 1934, as amended (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 Securities and Exchange Commission 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 CEO and 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.

There have been no changes in our internal controls 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. A copy may also be obtained, without charge, upon written request addressed to First Reliance Bancshares, Inc., 2170 W. Palmetto Street, P. O. Box 4250, 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 21, 2007, under the headings Proposal: Election of Directors , Security Ownership of Certain Beneficial Owners and Management, and Section 16(a) Beneficial Ownership Reporting Compliance 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 21, 2007, 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, 2006.

Equity Compensation Plan Table

	(a)	(b)	(c)
Plan category	**Number of securities to be issued upon exercise of outstanding options, warrants and rights**	**Weighted-average exercise price of outstanding options, warrants and rights**	**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	310,747	$ 7.86	0
Equity compensation plans not approved by security holders	63,517	$ 14.09	N/A
Total	374,264	$ 8.91	0

The equity compensation plans not approved by our shareholders include non-qualified option grants to five employees of the Company to purchase a total of 11,245 shares of the Company s common stock. All of the non-qualified option grants are fully vested as of December 31, 2006. The table below breaks down the exercise prices of the non-qualified options that have been granted by the Company.

Price	Number of Options
$9.32	2,800
$10.25	3,145
$11.00	5,000
$13.50	300

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. 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 21, 2007, 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 held on June 21, 2007, 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 21, 2007, 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.

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 30, 2007

POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears on the signature page to this Report constitutes and appoints F. R. Saunders, Jr. and Jeffrey A. Paolucci, his or her true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him or her and in his or her name, place, and stead, in any and all capacities, to sign any and all amendments to this Report, and to file the same, with all exhibits hereto, and other documents in connection herewith with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as they might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
F. R. Saunders, Jr.	Director, President and Chief Executive Officer (Principal Executive Officer)	March 30, 2007
Paul C. Saunders	Director	March 30, 2007
A. Dale Porter	Director	March 30, 2007
Leonard A. Hoogenboom	Chairman of the Board	March 30, 2007
John M. Jebaily	Director	March 30, 2007

Signature	Title	Date
Andrew G. Kampiziones	Director	March 30, 2007
C. Dale Lusk	Director	March 30, 2007
J. Munford Scott	Director	March 30, 2007
T. Daniel Turner	Director	March 30, 2007
A. Joe Willis	Director	March 30, 2007
Jeffrey A. Paolucci	Director, Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 30, 2007

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

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FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

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 of the Company, including the accompanying notes, included elsewhere herein.

(Dollars in thousands, except per share)	2006	2005	2004	2003	2002
Income Statement Data:					
Interest income	$ 31,717	$ 23,131	$ 13,291	$ 8,499	$ 6,932
Interest expense	14,214	8,979	4,061	2,460	2,337
Net interest income	17,503	14,152	9,230	6,039	4,595
Provision for loan losses	1,393	1,811	1,362	792	349
Net interest income after provision for loan losses	16,110	12,341	7,868	5,247	4,246
Noninterest income	4,591	2,871	2,380	2,138	1,734
Noninterest expense	16,272	12,475	8,338	5,966	4,680
Income before income taxes	4,429	2,737	1,910	1,419	1,300
Income tax expense	1,183	789	571	403	406
Net income	**$ 3,246**	**$ 1,948**	**$ 1,339**	**$ 1,016**	**$ 894**
Balance Sheet Data:					
Assets	$ 456,211	$ 403,038	$ 284,971	$ 180,364	$ 116,077
Earning assets	412,687	381,158	271,020	169,205	108,114
Securities available for sale[1]	35,931	37,121	28,568	27,689	23,449
Loans [2]	360,123	319,539	239,695	140,361	81,559
Allowance for loan losses	4,002	3,419	2,758	1,752	1,137
Deposits	372,938	334,437	225,494	139,415	100,323
Shareholders equity	34,093	29,651	27,359	17,703	8,644
Per-Share Data: [5]					
Basic earnings	$ 0.96	$ .60	$ 0.52	$ 0.48	$ 0.62
Diluted earnings	0.91	.57	0.48	0.46	0.59
Book value (period end)	9.95	8.97	8.54	7.18	5.97
Performance Ratios:					
Return on average assets	0.75%	0.54%	0.59%	0.70%	0.86%
Return on average equity	10.19	6.82	7.04	7.07	10.87
Net interest margin [3]	4.42	4.20	4.41	4.53	4.77
Efficiency [4]	73.65	73.28	71.82	72.99	74.89
Capital and Liquidity Ratios:					
Average equity to average assets	7.39%	7.96%	8.43%	9.93%	7.92%
Leverage (4.00% required minimum)	9.90	10.02	10.11	10.30	7.48
Risk-based capital					
Tier 1	11.42	12.02	11.36	12.60	10.21
Total	12.45	13.05	12.52	13.85	11.46
Average loans to average deposits	96.86	102.07	101.16	94.43	82.51

(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) Tax equivalent net interest income divided by average earning assets.
(4) Noninterest expense divided by the sum of net interest income and noninterest income, excluding gains and losses on sales of assets.
(5) Amounts have been restated for two for one stock split declared in 2002.

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

**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.

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, Charleston County, and Greenville County, South Carolina. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation.

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 First Reliance Bancshares, Inc.

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 Federal Deposit Insurance Corporation 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 being conducted in this facility.

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 through First Reliance Bank. The offering price was $8.00 per share. This was a best efforts offering and was conducted without an underwriter. The Company had sold 1,007,430 shares resulting in additional capital of $8,059,439 net of selling expenses of $162,965, at the close of the offering in May 2003. Also 10,400 stock options were exercised in 2003 for a total amount of $52,000.

During the second quarter of 2004, the Bank opened its third branch in Lexington, South Carolina. On March 15, 2005, the Bank opened its fourth branch in Charleston, South Carolina located at 51 State Street. The Bank also opened its fifth branch in Mount Pleasant, South Carolina located at 800 South Shelmore Blvd on October 3, 2005.

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Management s Discussion and Analysis
of Financial Condition and Results of Operations

General - *continued*

On June 30, 2005, the Company formed First Reliance Capital Trust I (the Trust) for the purpose of issuing trust preferred securities, which enabled the Company to obtain Tier 1 capital on a consolidated basis for regulatory purposes. On July 1, 2005, the Company closed a private offering of $10,000,000 of floating rate preferred securities offered and sold by the Trust. The proceeds from such issuance, together with the proceeds from a related issuance of common securities of the Trust purchased by the Company in the amount of $310,000, were invested by the Trust in floating rate Junior Subordinated Notes issued by the Company (the Notes) totaling $10.3 million. The Notes are due and payable on November 23, 2035 and may be redeemed by the Company after five years, and sooner in certain specific events, including in the event that certain circumstances render the Notes ineligible for treatment as Tier 1 capital, subject to prior approval by the Federal Reserve Board, if then required. The Notes presently qualify as Tier 1 capital for regulatory reporting. The sole assets of the Trust are the Notes. The Company owns 100% of the common securities of the Trust. The Notes are unsecured and rank junior to all senior debt of the Company. For the quarter ended December 31, 2006, the floating rate preferred securities and the Notes had an annual interest rate of 5.93%. This interest rate is fixed until August 23, 2010, when the interest rate will adjust quarterly. After August 23, 2010, the interest rate will equal three-month LIBOR plus 1.83%.

Like most financial institutions, our 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. Our results of operations are also affected by our 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.

Our balanced growth continued during 2006, with increases in assets, deposits, shareholders equity, earnings per share and returns on average assets and equity. The following chart shows our growth in these areas from December 31, 2005 to December 31, 2006:

(Dollars in millions)	December 31, 2006	December 31, 2005	Percent Increase (Decrease)
Total assets	$ 456.2	$ 403.0	13.19%
Loans	353.5	311.5	13.46
Investment securities	38.4	39.2	(1.91)
Deposits	372.9	334.4	11.51
Shareholders equity	34.1	29.7	14.98

The additional capital increased our legal lending limit, thereby allowing us to extend larger loans to our customers. Our loan portfolio increased $41.9 million from December 31, 2005 to December 31, 2006. Our deposit base also increased in 2006 by $38.5 million from $334.4 million in 2005 to $372.9 million in 2006.

The significant increase in average earning assets had a positive impact on our results of operations for 2006. Average earning assets increased from $341.8 million in 2005 to $401.0 million in 2006. Our increased volume in deposits also increased our fees from service charges and deposit accounts by approximately $334,699 from 2005 to 2006. Gains on sales of mortgage loans were also an important source of noninterest income in 2006, increasing $1.0 million, or 116.66% from $877,843 in 2005 to $1.9 million in 2006.

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Management s Discussion and Analysis
of Financial Condition and Results of Operations

Results of Operations

Year ended December 31, 2006, compared with year ended December 31, 2005 and December 31, 2004

Net interest income increased $3,350,453 or 23.67%, to $17,502,886 in 2006 from $14,152,433 in 2005. The increase in net interest income was due primarily to an increase in average earning assets. Average earning assets increased $59,839,000 or 17.35%, mainly due to continued growth in the loan portfolio. The primary components of interest income were interest on loans, including fees, of $29,222,425 and interest on taxable investment securities of $1,029,560. Net interest income increased $4,923,020, or 53.3%, to $14,152,433 in 2005 from $9,229,413 in 2004. The increase in net interest income was due primarily to an increase in average earning assets. Average earning assets increased $129,300,000 or 60.86%, mainly due to continued growth in the loan portfolio. The primary components of interest income were interest on loans, including fees, of $21,236,608, and interest on taxable investment securities of $770,863.

The Company s net interest spread and net interest margin were 3.96% and 4.42%, respectively, in 2006, compared to 3.78% and 4.20%, respectively, in 2005. The increase in net interest spread was primarily the result of an increase in average rates on earning assets which outpaced the increase in average rates on paying liabilities. Yields on loans, our largest category of earnings assets, increased in 2006. Overall yields on earning assets increased from 6.82% in 2005 to 7.96% in 2006. Yields on interest-bearing liabilities increased from 3.04% in 2005 to 4.00% in 2006. The Company s net interest spread and net interest margin were 3.78% and 4.20%, respectively, in 2005, compared to 4.08% and 4.41%, respectively, in 2004. The decrease in net interest spread was primarily the result of an increase in average rates on paying liabilities which outpaced the increase in average rates on earning assets. Yields on loans, our largest category of earnings assets, increased in 2005. Overall yields on earning assets increased from 6.32% in 2004 to 6.82% in 2005. Yields on interest-bearing liabilities increased from 2.24% in 2004 to 3.04% in 2005.

The provision for loan losses was $1,392,491 in 2006 compared to $1,811,317 in 2005. The allowance for loan losses was 1.13% of total loans at December 31, 2006 as compared to 1.10% of total loans at December 31, 2005. The Company continues to maintain the allowance for loan losses at a level management believes to be sufficient to cover known and inherent losses in the loan portfolio. The provision for loan losses was $1,811,317 in 2005 compared to $1,361,762 in 2004. The allowance for loan losses was 1.10% of total loans at December 31, 2005 as compared to 1.16% of total loans at December 31, 2004.

Noninterest income increased $1,719,406, or 59.88%, to $4,590,693 in 2006 from $2,871,287 in 2005. The increase is primarily attributable to gain on sale of mortgage loans and increased service charges on deposit accounts. The gain on sale of mortgage loans increased $1,024,124 or 116.66% to $1,901,967 for the year ended December 31, 2006 as the demand for new mortgage loans and refinancings remained strong. Service charges on deposit accounts increased $334,699, or 24.66% from 2005, to $1,691,913 for the year ended December 31, 2006. The increase in service charges on deposit accounts was attributable to an overall increase in the number of deposit accounts in 2006. Noninterest income increased $491,764, or 20.67%, to $2,871,287 in 2005 from $2,379,523 in 2004. The increase is primarily attributable to increased service charges on deposit accounts and other charges and gain on sale of mortgage loans. Service charges on deposit accounts increased $125,455, or 10.19% from 2004, to $1,357,214 for the year ended December 31, 2005. The increase in service charges on deposit accounts was attributable to an overall increase in the number of deposit accounts in 2005. The gain on sale of mortgage loans increased $293,820 or 50.31% to $877,843 for the year ended December 31, 2005 as the demand for new mortgage loans and refinancings remained strong. Securities and insurance brokerage income increased $28,943, or 21.99% from 2004, to $160,569 for the year ended December 31, 2005. The increase is primarily attributable to a successful marketing campaign.

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Management s Discussion and Analysis
of Financial Condition and Results of Operations

Results of Operations - *continued*

Noninterest expense increased $3,796,944, or 30.44%, to $16,272,385 in 2006 from $12,475,441 in 2005. Noninterest expenses increased in all categories as a result of our continued growth. The increase is primarily attributable to increased salaries and benefits and other operating expenses. Salaries and employee benefits increased $2,351,011, or 32.94%, to $9,487,387 in 2006 from $7,136,376 in 2005. A large portion of the increase in salaries was due to the addition of new staff to facilitate the new branch locations and growth of the Bank. Other operating expenses increased $1,219,663 from 2005 to $4,926,836 for the year ended December 31, 2006. This increase was due to the expected increases in overhead caused by the growth of the Company. The Company s efficiency ratio was 73.65% in 2006, compared to 73.28% in 2005. Noninterest expense increased $4,137,499, or 49.6%, to $12,475,441 in 2005 from $8,337,942 in 2004. Noninterest expenses increased in all categories as a result of our continued growth. The increase is primarily attributable to increased salaries and benefits and other operating expenses. Salaries and employee benefits increased $2,262,341, or 46.42%, to $7,136,376 in 2005 from $4,874,035 in 2004. A large portion of the increase in salaries was due to the addition of new staff to facilitate the new branch locations and growth of the Bank. Other operating expenses increased $1,285,138 from 2004 to $3,707,173 for the year ended December 31, 2005. This increase was due to the expected increases in overhead caused by the growth of the Company. The Company s efficiency ratio was 73.28% in 2005, compared to 71.82% in 2004.

Net income was $3,245,908 in 2006, compared to $1,947,546 in 2005. The increase in net income reflects the Company s continued growth, as average-earning assets increased from $341,757,000 for the year ended December 31, 2005 to $401,035,000 for the year ended December 31, 2006. Return on average assets during 2006 was 0.75%, compared to 0.54% during 2005, and return on average equity was 10.19% during 2006, compared to 6.82% during 2005. Net income was $1,947,546 in 2005, compared to $1,338,699 in 2004. The increase in net income reflects the Company s continued growth, as average-earning assets increased from $212,457,065 for the year ended December 31, 2004 to $341,757,173 for the year ended December 31, 2005. Return on average assets during 2005 was 0.54%, compared to 0.59% during 2004, and return on average equity was 6.82% during 2005, compared to 7.04% during 2004.

Net Interest Income

General. The largest component of the Company s net income is its net interest income, which is the difference between the income earned on assets and interest paid on deposits and on borrowings used to support such assets. Net interest income is determined by the yields earned on the Company s interest-earning assets and the rates paid on its 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 its interest-earning assets and interest-bearing liabilities. Total interest earning assets yield less total interest bearing liabilities rate represents the Company s net interest rate spread.

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Management s Discussion and Analysis
of Financial Condition and Results of Operations

Net Interest Income - *continued*

Average Balances, Income and Expenses, and Rates. The following table sets forth, for the years indicated, certain information related to the Company s 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.

Average Balances, Income and Expenses, and Rates

	2006			**2005**			**2004**		
Year ended December 31, ***(Dollars in thousands)***	**Average Balance**	**Income/ Expense**	**Yield/ Rate**	**Average Balance**	**Income/ Expense**	**Yield/ Rate**	**Average Balance**	**Income/ Expense**	**Yield/ Rate**
Assets:									
Earning Assets:									
Loans[(1)(2)]	$ 348,709	$ 29,222	8.38%	$ 294,740	$ 21,237	7.21%	$ 182,996	$ 12,094	6.61%
Securities, taxable[(2)]	21,891	1,030	4.70	17,491	771	4.41	17,266	723	4.19
Securities, tax exempt[(2)]	14,820	857	5.78	13,007	742	5.70	9,958	557	5.59
Federal funds sold and other	13,807	687	4.98	14,462	479	3.31	1,119	17	1.52
Nonmarketable equity securities	1,807	138	7.64	2,057	91	4.42	1,118	41	3.67
Total earning assets	401,035	31,934	7.96	341,757	23,320	6.82	212,457	13,432	6.32
Cash and due from banks	7,772			5,316			3,439		
Premises and equipment	11,445			7,379			5,862		
Other assets	14,757			7,596			5,799		
Allowance for loan losses	(3,764)			(3,150)			(2,110)		
Total assets	**$ 431,244**			**$ 358,898**			**$ 225,447**		
Liabilities:									
Interest-bearing liabilities:									
Interest-bearing transaction Accounts	$ 27,084	185	0.68%	$ 20,067	$ 153	0.76%	$ 15,985	$ 135	0.84%
Savings deposits	85,887	3,243	3.78	68,499	1,877	2.74	29,544	489	1.66
Time deposits	204,935	9,068	4.42	166,541	5,552	3.33	110,894	2,874	2.59
Junior subordinated debentures	10,310	618	5.99	4,875	306	6.28			
Other borrowings	27,154	1,100	4.05	35,041	1,090	3.11	24,506	563	2.30
Total interest-bearing liabilities	355,370	14,214	4.00	295,023	8,978	3.04	180,929	4,061	2.24
Demand deposits	42,100			33,652			24,474		
Accrued interest and other liabilities	1,911			1,666			1,036		
Shareholders equity	31,863			28,557			19,008		
Total liabilities and shareholders equity	**$ 431,244**			**$ 358,898**			**$ 225,447**		
Net interest spread			3.96%			3.78%			4.08%
Net interest income		**$ 17,720**			**$ 14,342**			**$ 9,371**	
Net interest margin			4.42%			4.20%			4.41%

(1) Nonaccrual loans are included in the balances. The effect of these loans is not significant to the computations. All loans and deposits are domestic.
(2) Fully tax-equivalent basis at 34% tax rate for non-taxable securities and loans.

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Rate/Volume Analysis

Analysis of Changes in Net Interest Income. Net interest income can also be analyzed in terms of the impact of changing rates and changing volume. The following table describes the extent to which changes in interest rates and changes in the volume of earning assets and interest-bearing liabilities have affected the Bank s interest income and interest expense during the periods indicated. Information on changes in each category attributable to (i) changes due to volume (change in volume multiplied by prior period rate), (ii) changes due to rates (changes in rates multiplied by prior period volume) and (iii) changes in rate/volume (change in rate multiplied by the change in volume) is provided in the table below. Changes to both rate and volume (in iii above) which cannot be segregated have been allocated proportionately.

	2006 Compared to 2005 Due to increase (decrease)in		
(Dollars in thousands)	**Volume**	**Rate**	**Total**
Interest income:			
Loans	$ 4,234	$ 3,751	$ 7,985
Securities, taxable	192	67	259
Securities, tax exempt	105	10	115
Federal funds sold and other	(23)	231	208
Nonmarketable equity securities	(2)	49	47
Total interest income	4,506	4,108	8,614
Interest expense:			
Interest-bearing deposits	49	(17)	32
Savings deposits	547	819	1,366
Time deposits	1,453	2,063	3,516
Junior subordinated debentures	327	(15)	312
Other borrowings	(277)	287	10
Total interest expense	2,099	3,137	5,236
Net interest income	**$ 2,407**	**$ 971**	**$ 3,378**

	2005 Compared to 2004 Due to increase (decrease) in		
(Dollars in thousands)	**Volume**	**Rate**	**Total**
Interest income:			
Loans	$ 7,966	$ 1,177	$ 9,143
Securities, taxable	9	39	48
Securities, tax exempt	174	11	185
Federal funds sold and other	421	41	452
Nonmarketable equity securities	33	17	50
Total interest income	8,603	1,285	9,888
Interest expense:			
Interest-bearing deposits	32	(14)	18
Savings deposits	927	461	1,388
Time deposits	1,705	973	2,678
Junior subordinated debentures	306		306

Other borrowings	289	238	527
Total interest expense	3,259	1,658	4,917
Net interest income	**$ 5,344**	**$ (373)**	**$ 4,971**

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Net Interest Income

Interest Sensitivity. The Company monitors and manages the pricing and maturity of its assets and liabilities in order to diminish the potential adverse impact that changes in interest rates could have on its net interest income. The principal monitoring technique employed by the Company is the measurement of the Company s 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 the Company s interest rate sensitivity at December 31, 2006.

Interest Sensitivity Analysis

December 31, 2006 *(Dollars in thousands)*	**Within One Month**	**After One Through Three Months**	**After Three Through Twelve Months**	**Within One Year**	**Greater Than One Year or Non-Sensitive**	**Total**
Assets						
Interest-earning assets						
Loans, including held for sale	$ 229,803	$ 4,381	$ 16,493	$ 250,677	$ 109,446	$ 360,123
Securities, taxable	539	314	1,336	2,189	18,656	20,845
Securities, nontaxable					15,086	15,086
Nonmarketable securities	2,188			2,188		2,188
Investment in trust					310	310
Federal funds sold	14,135			14,135		14,135
Total earning assets	246,665	4,695	17,829	269,189	143,498	412,687
Liabilities						
Interest-bearing liabilities:						
Interest-bearing deposits:						
Demand deposits	33,243			33,243		33,243
Savings deposits	78,832			78,832		78,832
Time deposits	16,565	53,523	124,049	194,137	24,619	218,756
Total interest-bearing deposits	128,640	53,523	124,049	306,212	24,619	330,831
Advances from Federal Home Loan Bank	10,500	9,000	8,000	27,500	1,000	28,500
Junior subordinated debentures					10,310	10,310
Repurchase agreements	8,120			8,120		8,120
Total interest-bearing liabilities	147,260	62,523	132,049	341,832	35,929	377,761
Period gap	**$ 99,405**	**$ (57,828)**	**$ (114,220)**	**$ (72,643)**	**$ 107,569**	
Cumulative gap	**$ 99,405**	**$ 41,577**	**$ (72,643)**	**$ (72,643)**	**$ 34,926**	
Ratio of cumulative gap to total earning assets	24.09%	10.07%	(17.60)%	(17.60)%	8.46%	

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Net Interest Income - *continued*

The above table reflects the balances of earning assets and interest-bearing liabilities at the earlier of their repricing or maturity dates. Federal funds sold are reflected at the earliest pricing interval due to the immediately available nature of the instruments. 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 the Company the opportunity to vary the rates paid on those deposits within one month or shorter period. However, the Company is not obligated to vary the rates paid on these deposits within any given period. Fixed rate time deposits, principally certificates of deposit, are reflected at their contractual maturity dates. Repurchase agreements mature on a daily basis and are reflected in the earliest pricing period. Advances from the Federal Home Loan Bank and junior subordinated debentures are reflected at their contractual maturity date.

The Company is in a liability sensitive position (or a negative gap) of $72.6 million over the 12 month time frame. The gap is negative when interest-bearing liabilities exceed interest sensitive earning assets, as was the case at the end of 2006 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.

The Company s Board of Directors and management review the Asset Liability Management with information obtained from our system which measure the interest rate sensitivity. The Company s asset and liability policies are to focus on maximizing long term profitability while managing acceptable interest rate risk.

However, the Company s gap analysis is not a precise indicator of its interest sensitivity position. The analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration 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. The Company has positioned itself where there is minimal impact on interest income in a rising or falling rate environment.

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Provision and Allowance for Loan Losses

General. The Company has developed policies and procedures for evaluating the overall quality of its credit portfolio and the timely identification of potential problem credits. On a quarterly basis, the Company s Board of Directors reviews and approves the appropriate level for the Company s allowance for loan losses based upon management s recommendations, the results of the internal monitoring and reporting system, and an analysis of economic conditions in its market. The objective of management has been to fund the allowance for loan losses at a level greater or equal to the Company s internal risk measurement system for loan risk. The Board maintained an allowance for loan losses level of 1.13% and 1.10% of total loans at December 31, 2006 and 2005, respectively. Management believes the allowance is adequate to meet any loan losses the Company may experience.

Additions to the allowance for loan losses, which are expensed as the provision for loan losses on the Company s income statement, 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 we believe will be adequate to absorb inherent losses on existing loans that may become uncollectible. Our judgment in determining the adequacy of the allowance is based on evaluations of the collectibility 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 limited historical loan loss experience and a review of specific problem loans.

The Company adjusts the amount of the allowance periodically based on changing circumstances as a component of the provision for loan losses. We charge recognized losses against the allowance and add subsequent recoveries back to the allowance. We do not allocate the allowance for loan losses to specific categories of loans (i.e., real estate, consumer, commercial and mortgage), but evaluate the adequacy on an overall portfolio basis utilizing our credit grading system which we apply to each loan. We combine our estimates of the reserves needed for each component of the portfolio, including loans analyzed on a pool basis and loans analyzed individually. The allowance is divided into two portions: (1) an amount for specific allocations on significant individual credits and (2) a general reserve amount. We analyze individual loans within the portfolio and make allocations to the allowance based on each individual loan s specific factors and other circumstances that affect the collectibility of the credit. Significant, individual credits classified as doubtful or substandard/special mention within our credit grading system require both individual analysis and specific allocation. Loans in the substandard category are characterized by deterioration in quality exhibited by any number of well-defined weaknesses requiring corrective action such as declining or negative earnings trends and declining or inadequate liquidity. Loans in the doubtful category exhibit the same weaknesses found in the substandard loan; however, the weaknesses are more pronounced. However, these loans are not yet rated as loss because certain events may occur which could salvage the debt such as injection of capital, alternative financing or liquidation of assets. As of December 31, 2006 and 2005, the Company had no specific allocations on its significant credits in its calculation of the allowance for loan losses.

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Provision and Allowance for Loan Losses - *continued*

The Company calculates its general reserve based on percentages tied to our credit grading system. Each loan is assigned one of eight loan risk ratings, based on the loan s specific characteristics. Any loan assigned an adverse ranking is specifically allocated a loss. For all remaining loans, the general reserve amount is calculated based upon a reserve percentage for each risk rating. The Company may adjust these percentages as appropriate given consideration of local economic conditions, exposure concentration that may exist in the portfolio, changes in trends of past due loans, problem loans and charge-offs and anticipated loan growth.

The Bank has developed a loan risk monitoring system that assesses the potential risk the Bank may have in its loan portfolio. This system is monitored monthly by management to insure that adequate provisions and loan allowances are maintained. In addition, various regulatory agencies review our allowance for loan losses through their periodic examinations, and they may require us to record additions to the allowance for loan losses based on their judgment about information available to them 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, 2006, the Company s general reserves totaled $4,001,881, an increase of $582,513 from 2005. As of December 31, 2005, the Company s general reserves totaled $3,419,368, an increase of $661,143 from 2004. The categories and concentrations of loans have been consistent between the past two years.

The following table sets forth certain information with respect to the Company s allowance for loan losses and the composition of chargeoffs and recoveries for the years ended December 31, 2006, 2005, 2004, 2003 and 2002.

Allowance for Loan Losses

(Dollars in thousands)	2006	2005	2004	2003	2002
Total loans outstanding at end of year	**$ 353,491**	**$ 311,544**	**$ 238,362**	**$ 139,389**	**$ 81,558**
Average loans outstanding	**$ 348,709**	**$ 294,740**	**$ 182,996**	**$ 100,051**	**$ 73,777**
Balance of allowance for loan losses at beginning of year	$ 3,419	$ 2,758	$ 1,752	$ 1,137	$ 1,045
Loans charged off:					
Real estate - construction	17	142			
Real estate - mortgage	718	472	166	47	32
Commercial and industrial	170	317	44	42	78
Consumer and other	151	300	181	106	185
Total loan losses	1,056	1,231	391	195	295
Recoveries of previous loan losses:					
Real estate - construction					
Real estate - mortgage	105	38			2
Commercial and industrial	111	12			
Consumer and other	31	31	35	18	36
Total recoveries	247	81	35	18	38
Net charge-offs	809	1,150	356	177	257
Provision for loan losses	1,392	1,811	1,362	792	349
Balance of allowance for loan losses at end of year	**$ 4,002**	**$ 3,419**	**$ 2,758**	**$ 1,752**	**$ 1,137**
Ratios:					
Net charge-offs to average loans outstanding	0.23%	0.39%	0.20%	0.18%	0.35%

Net charge-offs to loans at end of year	0.23	0.37	0.15	0.13	0.32
Allowance for loan losses to average loans	1.15	1.16	1.51	1.75	1.54
Allowance for loan losses to loans at end of year	1.13	1.10	1.16	1.26	1.39
Net charge-offs to allowance for loan losses	20.21	33.64	12.90	10.10	22.60
Net charge-offs to provisions for loan losses	58.11	63.50	26.13	22.35	73.64

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Nonperforming Assets

Nonperforming Assets. There were $670,650 and $1,792,702 loans in nonaccrual status at December 31, 2006 and 2005, respectively. There were $463,991 and $704,800 in loans ninety days or more overdue and still accruing interest at December 31, 2006 and 2005, respectively. There were $137,421 and $285,000 in restructured loans at December 31, 2006 and 2005, respectively.

The following table shows the nonperforming assets, percentages of net charge-offs, and the related percentage of allowance for loan losses for the five years ended December 31, 2006. All loans over 90 days past due are on and included in loans on nonaccrual.

(Dollars in thousands)	**2006**	**2005**	**2004**	**2003**	**2002**
Loans over 90 days past due and still accruing	$ 464	$ 705	$ 59	$ 460	$ 585
Loans on nonaccrual:					
Mortgage	637	1,619	1,078		90
Commercial	0	95	17		155
Consumer	34	78	91		47
Total nonaccrual loans	671	1,792	1,186		292
Total of nonperforming loans	1,135	2,497	1,245	460	877
Other nonperforming assets	1,386	346	321	279	121
Total nonperforming assets	**$ 2,521**	**$ 2,843**	**$ 1,566**	**$ 739**	**$ 998**
Percentage of total assets	0.55%	0.71%	0.55%	0.41%	0.86%
Percentage of nonperforming loans and assets to gross loans	0.71%	0.91%	0.66%	0.53%	1.25%
Allowance for loan losses to gross loans	1.13%	1.10%	1.16%	1.26%	1.39%
Net charge-offs to average loans	0.23%	0.39%	0.19%	0.18%	0.35%

Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions and collection efforts, the borrower s financial condition is such that the collection of interest is doubtful. A delinquent loan is generally placed in nonaccrual status when it becomes 90 days or more past due. When a loan is placed in nonaccrual status, all interest which has been accrued on the loan but remains unpaid is reversed and deducted from current earnings as a reduction of reported interest income. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain. When a problem loan is finally resolved, there may ultimately be an actual write-down or chargeoff of the principal balance of the loan which would necessitate additional charges to earnings. For all periods presented, the additional interest income, which would have been recognized into earnings if the Company s nonaccrual loans had been current in accordance with their original terms, and the amount of interest income on such loans that was included in net income is immaterial.

Potential Problem Loans. At December 31, 2006, the Company had classified loans totaling $2,697,063 as compared to $3,767,776 at December 31, 2005. Classified loans as a percentage of total loans was 0.76% at December 31, 2006 as compared to 1.21% at December 31, 2005. The loan portfolio increased 13.46% during the same period.

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Noninterest Income and Expense

Noninterest Income. Noninterest income for year ended December 31, 2006 was $4,590,693, an increase of $1,719,406 from $2,871,287 in 2005. The increase is primarily attributable to increased service charges on deposit accounts and gain on sale of mortgage loans. Deposit service charges increased $334,699 or 24.66% from 2005, to $1,691,913 for the year ended December 31, 2006. The increase in service charges on deposit accounts was attributable to an overall increase in the number of deposit accounts in 2006. This increase is attributable to market conditions and a successful marketing campaign. The gain on sale of mortgage loans increased $1,024,124 or 116.67% to $1,901,967 in 2006, from $877,843 in 2005. Noninterest income for year ended December 31, 2005 was $2,871,287, an increase of $491,764 from $2,379,523 in 2004. The increase is primarily attributable to increased service charges on deposit accounts and gain on sale of mortgage loans. Service charges increased $125,455, or 10.19% from 2004, to $1,357,214 for the year ended December 31, 2005. The increase in service charges on deposit accounts was attributable to an overall increase in the number of deposit accounts in 2005. This increase is attributable to market conditions and a successful marketing campaign. The gain on sale of mortgage loans increased $293,820, or 50.31%, to $877,843 in 2005, from $584,023 in 2004. Securities and brokerage commissions increased $28,943, or 21.99%, to $160,569 in 2005 from $131,626 in 2004.

The following table sets forth the principal components of noninterest income for the years ended December 31, 2006, 2005 and 2004.

(Dollars in thousands)	2006	2005	2004
Service charges on deposit accounts	$ 1,692	$ 1,357	$ 1,232
Credit life insurance commissions	23	33	82
Gain on sale of mortgage loans	1,902	878	584
Securities and insurance brokerage commissions	138	161	132
Other income	836	442	350
Total noninterest income	**$ 4,591**	**$ 2,871**	**$ 2,380**

Noninterest Expense. Noninterest expense increased $3,796,943 or 30.44%, to $16,272,384 for year ended December 31, 2006 as compared to 2005. Of this total, other operating expenses increased $1,219,663 or 32.90%, to $4,926,835 in 2006 from $3,707,173 in 2005. Salaries and employee benefits increased $2,351,011 or 32.94%, to $9,487,387 in 2006 from $7,136,376 in 2005. This increase is primarily attributable to new hire employee compensation as the Bank expands into different markets. Net occupancy and equipment expense increased $226,270 or 13.87%, to $1,858,162 in 2006 largely due to operating costs associated with the Bank s branch expansion effort in 2006. Noninterest expense increased $4,137,499, or 49.62%, to $12,475,441 for year ended December 31, 2005 as compared to 2004. Of this total, other operating expenses increased $1,285,138, or 53.06%, to $3,707,173 in 2005 from $2,422,035 in 2004. Salaries and employee benefits increased $2,262,341, or 46.42%, to $7,136,376 in 2005 from $4,874,035 in 2004. This increase is primarily attributable to new hire employee compensation as the Bank expands into different markets. Net occupancy and equipment expense increased $590,020, or 56.63%, to $1,631,892 in 2005 largely due to operating costs associated with the Bank s branch expansion effort in 2005.

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Noninterest Income and Expense - *continued*

The following table sets forth the primary components of noninterest expense for the years ended December 31, 2006, 2005 and 2004.

(Dollars in thousands)	2006	2005	2004
Salaries and employee benefits	$ 9,487	$ 7,136	$ 4,874
Net occupancy	1,131	920	426
Furniture and equipment	727	712	616
Advertising and public relations	373	292	101
Office supplies, stationery, and printing	275	224	145
Data processing and supplies	32	21	13
Computer and software	441	483	342
Professional fees and services	471	431	193
Employee education and conventions	65	60	49
Loan origination costs	208	106	103
Other	3,062	2,090	1,476
Total noninterest expense	**$ 16,272**	**$ 12,475**	**$ 8,338**
Efficiency ratio	73.65%	73.28%	71.82%

Earning Assets

Loans. Loans 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 $348,709,226 in 2006 compared to $294,740,266 in 2005, an increase of $53,968,960 or 18.31%. At December 31, 2006, total loans were $353,491,036 compared to $311,544,385 at December 31, 2005, an increase of $41,946,651 or 13.46%.

The following table sets forth the composition of the loan portfolio by category at the dates indicated and highlights the Company s general emphasis on all types of lending.

Composition of Loan Portfolio

	2006		2005		2004	
December 31, *(Dollars in thousands)*	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Commercial and industrial	$ 51,710	14.63%	$ 50,320	16.15	$ 47,890	20.09%
Real estate						
Construction	64,118	18.14	52,268	16.78	39,023	16.37
Mortgage-residential	91,039	25.75	86,716	27.83	69,921	29.33
Mortgage-nonresidential	127,214	35.99	106,125	34.06	63,189	26.51
Consumer	12,729	3.60	13,953	4.48	13,931	5.84
Other	6,681	1.89	2,162	0.70	4,408	1.86
Total loans	353,491	100.00%	311,544	**100.00**%	238,362	**100.00%**
Allowance for loan losses						