



Annual Report

2021

TO OUR SHAREHOLDERS:



The past two years have presented a cultural and economic landscape that may be unprecedented in our collective memory: a global pandemic, a deep recession and subsequent recovery, severe supply chain disruption, and mounting inflationary pressures. Add to that an increasingly fraught geopolitical environment, highlighted by Russia's invasion of Ukraine, and it's easy to understand why some in our community are feeling overwhelmed.

However, despite these challenges, I am proud that First Reliance Bank, along with financial institutions everywhere, have become a source of strength and support for our customers and communities during this time. We worked tirelessly this past year to meet the financial needs of our customers, including by participating in the second round of the SBA's Paycheck Protection Program (PPP), which allowed them to weather the worst effects of the pandemic and its economic disruption. Our customers trust us to be there in times of need and we remain committed to earning that trust and developing strong relationships built upon it.

For First Reliance Bank, 2021 was highlighted by strong organic growth in both loans and deposits as well as significant investments in both our commercial and mortgage production teams. We continue to execute on our strategic plan, highlighted by a 23% growth in loans, a 32% growth in deposits, and a decrease in nonperforming assets to 0.10% of total assets.

Our Markets

We've continued to see strong loan production and deposit growth in all of our major markets, highlighted by significant growth in the Greenville, Midlands, and Charleston markets. We remain focused on deepening our market share within all of our existing markets and believe we are well-positioned to do so.

During 2021, we moved into our new downtown Columbia branch at 1901 Main Street, which deepens our presence in the Midlands. Additionally, in order to support growth across our company, we purchased and renovated a building in the Charleston area for use as a Corporate Center, which now houses associates in operations, accounting/finance, and human resources.

Year in Review

Our Commercial division originated \$260 million in new loans in 2021, helping approximately 2,800 people start a business, expand a business, prepare for retirement, create wealth, and make investments. First Reliance Bank was a participating lender in the second round of PPP, during which we directly originated 262 loans totaling \$20.5 million.

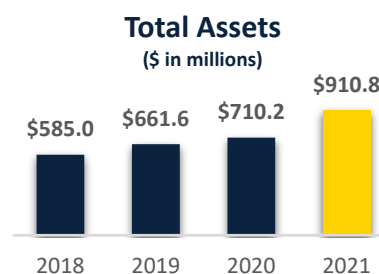
Our Retail division opened approximately 4,500 new deposit accounts in 2021 and deepened customer relationships in all of our markets. Customers continue to like the brand of banking they receive from First Reliance Bank, which is reflected in our 92% customer retention rate and a 93% customer satisfaction rating. Our Call Center processed over 93,000 incoming calls during the year, helping our customers solve a problem, answer a question, or get banking assistance from a dedicated associate.

With borrowing rates remaining low during 2021, our mortgage division, First Reliance Mortgage, had another outstanding year, originating \$504 million in mortgages, helping approximately 2,300 people purchase a new home or refinance an existing mortgage – including 563 first time home buyers. In addition, as of year-end, we were servicing over 7,700 mortgage loans with a combined balance of approximately \$1.4 billion dollars.

Net income for the year was \$5.3 million, or \$0.65 per diluted share, compared to \$10.6 million or \$1.32 per diluted share for the same period a year ago. This decrease primarily reflects the cyclical nature of our mortgage division, which produced historic profits in 2020 and began to normalize in 2021. For the core banking business, 2021 proved to be a year of growth, and we believe we are well positioned to continue improving operating leverage. Additionally, the rise in the yield curve should provide opportunities to accelerate our deployment of cash into investment securities as well as achieve increased yields in new loan originations. Our strong deposit franchise should allow us to have low deposit betas in this rising rate environment.

Asset Growth

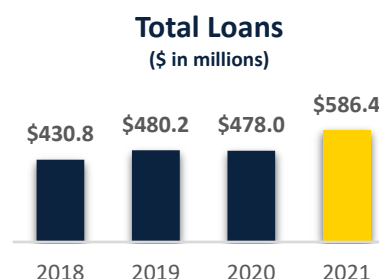
During 2021, we grew assets by \$200.6 million, or 28%, from \$710.2 million at December 31, 2020 to \$910.8 million at December 31, 2021. This growth was mainly driven by an increase in cash, investment securities, and loans.



Loan Growth and Asset Quality

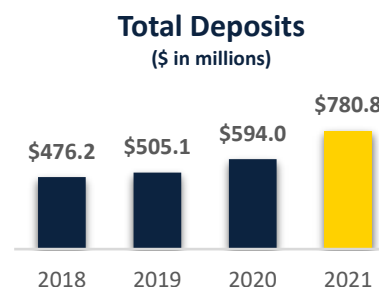
During 2021, we grew loans by \$108.5 million, or 23%, from \$478.0 million at December 31, 2020 to \$586.4 million at December 31, 2021.

Our asset quality remained strong during the year, with the ratio of nonperforming assets to total assets decreasing to 0.10% at December 31, 2021 from 0.21% at December 31, 2020.



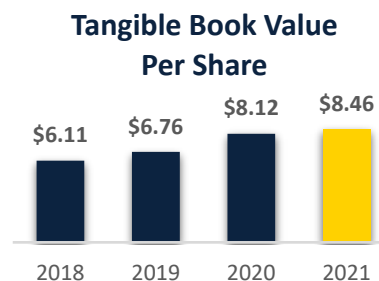
Deposit Growth

During 2021, we grew deposits by \$186.8 million, or 32%, from \$594.0 million at December 31, 2020 to \$780.8 million at December 31, 2021. Transaction accounts increased by \$103.7 million during the year and made up over 50% of total deposits at year-end. This deposit mix helped lower our cost of funds from 0.59% during 2020 to 0.27% during 2021.



Tangible Book Value

One of the best measures of our success in building value for our shareholders is tangible book value per share. During 2021, tangible book value per share continued to grow, reaching \$8.46 at December 31, 2021, a reflection of strong underlying performance in key business areas.



Technology

The pandemic further accelerated an ongoing trend in banking – consumers and businesses want to do more of their banking digitally. As a result, we expanded our digital services and partnered with a best-in-class mobile banking provider, which allows us to offer more digital services and convenience to our customers. We will continue to make investments in technology to improve operations and security and to enhance our products and services. Our goal is to be the preferred choice for customers looking for a local financial institution with 21st century banking capabilities. Embracing this challenge is critical to staying in business.

Competition

Community banks operate in a very demanding competitive environment. Along with the traditional competitors, there is a growing sector of non-banks – from payments companies to fintechs – that now compete with community banks for market share. The pace of change and size of competition is unprecedented, and we must remain proactive in order to execute our growth strategy in this environment.

Our People

A major difference in this competitive landscape is our people and our focus on high-touch service. Clients with a question can contact their banker by phone, text, or email, or they can come into the local branch to meet in person. Our people live and work in the same communities as our customers. Our customer value proposition includes providing our customers with an amazing experience, caring about their financial success, and building trustworthy relationships. We recognize the need to offer our customers banking solutions as unique as they are.

Additionally, we have built a strong leadership team with tremendous character and capabilities to shepherd our way through the challenges of the current banking environment and to execute our company's strategy. They have brought about a lot of positive change to the company, and we're excited to continue pursuing our vision of safe and sound, profitable growth.

In Closing

We have been consistent about maintaining a strong balance sheet, investing in talent, and implementing controls and processes that can scale. We will do this while remaining focused on developing relationships and meeting the financial needs of our customers. Going forward, we will continue striving to be a **Great Place to Work, a Great Place to Bank, and a Great Place to Invest.**

I am sincerely grateful and appreciative for our 180+ employees and their families. They have faced these times with purpose and strength, and I hope you are as proud of them as I am.

Thank you for your continued support,

F.R. "Rick" Saunders Jr.
Chief Executive Officer



First Reliance Bancshares, Inc. and Subsidiary

Report on Consolidated Financial Statements

As of and for the years ended December 31, 2021 and 2020

First Reliance Bancshares, Inc. and Subsidiary

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Independent Auditor's Report

The Board of Directors
First Reliance Bancshares, Inc. and Subsidiary
Florence, South Carolina

Opinion

We have audited the consolidated financial statements of First Reliance Bancshares, Inc. and its Subsidiary (the "Company"), which comprise the consolidated balance sheets as of December 31, 2021 and 2020, the related consolidated statements of operations, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2021 and 2020, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of the Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable).

Independent Auditor's Report, Continued

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.



Columbia, South Carolina
March 28, 2022

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Balance Sheets
As of December 31, 2021 and 2020

	<u>2021</u>	<u>2020</u>
Assets		
Cash and cash equivalents:		
Cash and due from banks	\$ 5,299,431	\$ 5,521,448
Interest-bearing deposits with other banks	144,824,529	93,167,467
Total cash and cash equivalents	<u>150,123,960</u>	<u>98,688,915</u>
Time deposits in other banks	257,173	255,638
Marketable equity securities	137,859	29,424
Securities available-for-sale	81,779,260	32,729,894
Nonmarketable equity securities	837,000	1,076,400
Total investment securities	<u>82,754,119</u>	<u>33,835,718</u>
Mortgage loans held for sale	23,844,303	35,641,877
Loans receivable	586,445,473	477,967,634
Less allowance for loan losses	<u>(7,039,576)</u>	<u>(6,172,977)</u>
Loans, net	<u>579,405,897</u>	<u>471,794,657</u>
Premises, furniture and equipment, net	22,805,006	18,490,548
Accrued interest receivable	1,703,143	1,545,861
Other real estate owned	135,000	164,295
Cash surrender value life insurance	18,475,896	18,101,821
Net deferred tax assets	4,128,214	3,452,005
Mortgage servicing rights	14,057,097	12,020,612
Core deposit intangibles	244,474	366,454
Goodwill	690,917	690,917
Right of use asset	6,634,220	5,360,111
Other assets	5,537,376	9,758,115
Total assets	<u>\$ 910,796,795</u>	<u>\$ 710,167,544</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing transaction accounts	\$ 238,018,563	\$ 167,274,049
Interest-bearing transaction accounts	153,888,994	120,890,658
Savings	262,998,387	166,403,732
Time deposits \$250,000 and over	26,868,239	34,103,856
Other time deposits	99,059,140	105,327,947
Total deposits	<u>780,833,323</u>	<u>594,000,242</u>
Securities sold under agreement to repurchase	11,372,325	5,522,872
Advances from Federal Home Loan Bank	10,000,000	10,000,000
Subordinated debentures	15,349,205	10,486,998
Junior subordinated debentures	10,310,000	10,310,000
Accrued interest payable	142,732	255,722
Lease liability	6,781,650	5,433,137
Other liabilities	5,205,909	5,430,720
Total liabilities	<u>839,995,144</u>	<u>641,439,691</u>
Shareholders' Equity		
Series D non-cumulative preferred stock, no par value; 70,000 shares authorized; 54,732 and 55,932 shares issued and outstanding at December 31, 2021 and 2020, respectively	547	559
Common stock, \$0.01 par value; 20,000,000 shares authorized; 8,793,108 and 8,153,557 shares issued; and 8,258,410 and 7,919,233 shares outstanding at December 31, 2021 and 2020, respectively	87,931	81,536
Non voting common stock, \$0.01 par value; 430,000 shares authorized, 0 and 410,499 shares issued and outstanding at December 31, 2021 and 2020, respectively	-	4,105
Capital surplus	53,855,594	51,971,579
Treasury stock, at cost, 534,698 and 234,324 shares at December 31, 2021 and 2020, respectively	(4,322,496)	(1,679,952)
Nonvested restricted stock	(2,668,238)	(1,486,440)
Retained earnings	23,985,343	18,708,605
Accumulated other comprehensive income (loss)	<u>(137,030)</u>	<u>1,127,861</u>
Total shareholders' equity	<u>70,801,651</u>	<u>68,727,853</u>
Total liabilities and shareholders' equity	<u>\$ 910,796,795</u>	<u>\$ 710,167,544</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Operations
For the years ended December 31, 2021 and 2020

	<u>2021</u>	<u>2020</u>
Interest income:		
Loans, including fees	\$ 25,285,559	\$ 26,776,516
Investment securities:		
Taxable	1,052,207	920,042
Tax exempt	150,927	150,891
Other interest income	<u>234,522</u>	<u>273,229</u>
Total	<u>26,723,215</u>	<u>28,120,678</u>
Interest expense:		
Deposits	1,034,912	2,386,091
Federal Home Loan Bank advances	164,250	638,290
Subordinated debentures	808,249	814,143
Other interest expense	<u>10,673</u>	<u>31,285</u>
Total	<u>2,018,084</u>	<u>3,869,809</u>
Net interest income	24,705,131	24,250,869
Provision for loan losses	<u>302,700</u>	<u>2,908,000</u>
Net interest income after provision for loan losses	<u>24,402,431</u>	<u>21,342,869</u>
Noninterest income:		
Mortgage banking income	9,531,044	19,524,103
Service charges on deposit accounts	1,221,059	1,309,797
Other service charges, commissions, and fees	2,038,201	1,596,729
Income from bank owned life insurance	374,075	409,436
Gain (loss) on sale of investment securities	81,176	(211,018)
Gain on sale of loans	326,275	-
Gain (loss) on disposal of fixed assets	68,912	(528,357)
Loss on extinguishment of debt	-	(287,199)
Other	<u>562,035</u>	<u>396,976</u>
Total	<u>14,202,777</u>	<u>22,210,467</u>
Noninterest expenses:		
Salaries and benefits	20,742,059	18,229,345
Occupancy and equipment	3,221,157	3,132,880
Data processing, technology, and communications	3,554,112	3,063,756
Professional fees	916,302	1,130,491
Marketing	419,137	409,964
Other	<u>3,344,795</u>	<u>3,692,063</u>
Total	<u>32,197,562</u>	<u>29,658,499</u>
Income before income taxes	<u>6,407,646</u>	<u>13,894,837</u>
Income tax expense	1,130,908	3,278,687
Net income	<u>\$ 5,276,738</u>	<u>\$ 10,616,150</u>
Average common shares outstanding, basic	7,749,029	7,919,406
Average common shares outstanding, diluted	8,142,101	8,037,601
Income per common share:		
Basic income per common share	\$ 0.68	\$ 1.34
Diluted income per common share	0.65	1.32

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Comprehensive Income
For the years ended December 31, 2021 and 2020

	<u>2021</u>	<u>2020</u>
Net income	\$ 5,276,738	\$ 10,616,150
Other comprehensive income (loss), net of tax:		
Unrealized holding gains (losses) on securities available-for-sale	(1,603,996)	856,232
Reclassification adjustment for realized (gains) losses included in earnings	(81,176)	211,018
Income tax benefit (expense)	<u>420,281</u>	<u>(247,677)</u>
Other comprehensive income (loss), net of tax	<u>(1,264,891)</u>	<u>819,573</u>
Comprehensive income	<u>\$ 4,011,847</u>	<u>\$ 11,435,723</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
For the years ended December 31, 2021 and 2020

	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Capital Surplus</u>	<u>Treasury Stock</u>	<u>Nonvested Restricted Stock</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
Balance, December 31, 2019	572	84,441	51,136,879	(1,283,469)	(1,253,706)	8,092,455	308,288	57,085,460
Net income	-	-	-	-	-	10,616,150	-	10,616,150
Other comprehensive income, net of tax	-	-	-	-	-	-	819,573	819,573
Conversion of Preferred Stock - Series D to Common Stock	(13)	13	-	-	-	-	-	-
Net issuance of Common Stock	-	1,187	775,855	-	-	-	-	777,042
Net change in restricted stock	-	-	-	-	(232,734)	-	-	(232,734)
Stock based compensation	-	-	58,845	-	-	-	-	58,845
Purchase of treasury stock	-	-	-	(396,483)	-	-	-	(396,483)
Balance, December 31, 2020	559	85,641	51,971,579	(1,679,952)	(1,486,440)	18,708,605	1,127,861	68,727,853
Net income	-	-	-	-	-	5,276,738	-	5,276,738
Other comprehensive loss, net of tax	-	-	-	-	-	-	(1,264,891)	(1,264,891)
Conversion of Preferred Stock - Series D to Common Stock	(12)	12	-	-	-	-	-	-
Net issuance of Common Stock	-	2,278	1,800,944	-	-	-	-	1,803,222
Net change in restricted stock	-	-	-	-	(1,181,798)	-	-	(1,181,798)
Stock based compensation	-	-	83,071	-	-	-	-	83,071
Purchase of treasury stock	-	-	-	(2,642,544)	-	-	-	(2,642,544)
Balance, December 31, 2021	<u>\$ 547</u>	<u>\$ 87,931</u>	<u>\$ 53,855,594</u>	<u>\$ (4,322,496)</u>	<u>\$ (2,668,238)</u>	<u>\$ 23,985,343</u>	<u>\$ (137,030)</u>	<u>\$ 70,801,651</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Cash Flows
For the years ended December 31, 2021 and 2020

	<u>2021</u>	<u>2020</u>
Cash flows from operating activities:		
Net income	\$ 5,276,738	\$ 10,616,150
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	302,700	2,908,000
Depreciation expense	935,042	811,654
(Gain) loss on change in fair value of marketable equity securities	(8,435)	1,471
Discount accretion and premium amortization on investment securities	177,263	75,516
Discount accretion on purchased loans	(201,896)	(284,393)
(Gain) loss on disposal of fixed assets	(68,912)	528,357
Net gain on sale of other real estate owned	-	(62,027)
(Gain) loss on sale of investment securities	(81,176)	211,018
Write down of other real estate owned	29,295	-
Originations of mortgages held for sale	(503,886,940)	(672,380,825)
Proceeds from sales of mortgages held for sale	525,215,558	684,164,470
Mortgage banking income	(9,531,044)	(19,524,103)
Proceeds from sale of Paycheck Protection Program loans	20,352,492	30,320,468
(Gain) loss on sale of loans	(326,275)	-
Core deposit intangible amortization	121,980	146,581
Loss on extinguishment of debt	-	287,199
Amortization of debt issuance costs	20,939	21,784
Deferred income taxes, net of allowance	(255,927)	2,851,747
Increase in cash surrender value of life insurance	(374,075)	(409,436)
Stock based compensation expense	83,071	58,845
Increase in mortgage servicing rights, net	(2,036,485)	(997,974)
Increase in accrued interest receivable	(157,282)	(72,280)
(Increase) decrease in other assets	4,598,034	(5,924,322)
Decrease in accrued interest payable	(112,990)	(160,580)
Increase (decrease) in other liabilities	(527,703)	1,265,694
Net cash provided by operating activities	<u>39,543,972</u>	<u>34,453,014</u>
Cash flows from investing activities:		
Purchases of securities available-for-sale	(67,859,431)	(1,000,000)
Purchases of marketable equity securities	(100,000)	-
Maturities of securities available-for-sale	9,977,087	10,758,505
Maturities of securities held-to-maturity	-	1,693,631
Proceeds on sales of securities available-for-sale	7,051,719	2,700,000
Net decrease in nonmarketable equity securities	239,400	1,346,800
Net increase in time deposits in other banks	(1,535)	(1,727)
Net increase in loans receivable	(127,738,261)	(28,127,914)
Purchases of premises, furniture and equipment	(5,180,588)	(1,133,733)
Proceeds from disposal of premises, furniture and equipment	-	1,723,680
Proceeds from sale of other real estate owned	-	290,006
Net cash used in investing activities	<u>(183,611,609)</u>	<u>(11,750,752)</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary

Consolidated Statements of Cash Flows

For the years ended December 31, 2021 and 2020

	<u>2021</u>	<u>2020</u>
Cash flows from financing activities:		
Net increase in demand deposits, interest-bearing transaction accounts and savings accounts	200,337,505	107,615,850
Net decrease in certificates of deposit and other time deposits	(13,504,424)	(18,703,245)
Net decrease in advances from Federal Home Loan Bank	-	(33,300,000)
Net decrease in federal funds purchased	-	(16,500,000)
Net increase (decrease) in securities sold under agreements to repurchase	5,849,453	(9,114,460)
Issuance of subordinated debentures, net of issuance costs	9,841,268	5,500,000
Redemption of subordinated debentures	(5,000,000)	-
Issuance of common stock	1,803,222	777,042
Increase in nonvested restricted stock	(1,181,798)	(232,734)
Purchase of treasury stock	<u>(2,642,544)</u>	<u>(396,483)</u>
Net cash provided by financing activities	<u>195,502,682</u>	<u>35,645,970</u>
Net increase cash and cash equivalents	51,435,045	58,348,232
Cash and cash equivalents, beginning of year	<u>98,688,915</u>	<u>40,340,683</u>
Cash and cash equivalents, end of year	<u>\$ 150,123,960</u>	<u>\$ 98,688,915</u>
Cash paid during the year for:		
Income taxes	\$ 1,705,251	\$ 348,416
Interest	2,131,074	4,030,389
Supplemental noncash investing and financing activities:		
Transfer from loans to other real estate owned	\$ -	\$ 44,722
Transfer of securities held-to-maturity to securities available-for-sale	-	8,723,537
Net change in unrealized gains on investment securities	(1,264,891)	819,573
Initial recognition of right-of-use asset	1,651,405	-
Initial recognition of lease liability	1,651,405	-

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies

Organization:

First Reliance Bancshares, Inc. (the "Company") was incorporated under the laws of the State of South Carolina on April 12, 2001 to serve as a bank holding company for its subsidiary, First Reliance Bank (the "Bank"), and acquired all of the shares of the Bank on April 1, 2002 in a statutory share exchange. First Reliance Bank was incorporated on August 9, 1999 and commenced business on August 16, 1999. The principal business activity of the Bank is to provide banking services to domestic markets throughout South Carolina and North Carolina. The Bank is a South Carolina chartered commercial bank, and its deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"). The consolidated financial statements include the accounts of the parent company and its wholly-owned subsidiary after elimination of all significant intercompany balances and transactions. In 2005, the Company formed First Reliance Capital Trust I (the "Trust") for the purpose of issuing trust preferred securities. In accordance with current accounting guidance, the Trust is not consolidated in these financial statements.

Management's estimates:

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

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

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

Concentrations of credit risk:

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

The Company makes loans to individuals and small businesses for various personal and commercial purposes primarily throughout South Carolina and North Carolina. At December 31, 2021 and 2020, the majority of the total loan portfolio was to borrowers from within these areas.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Concentrations of credit risk, continued:

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

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

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

Debt securities available-for-sale:

Debt securities available-for-sale are carried at amortized cost and adjusted to fair value by recognizing the aggregate unrealized gains or losses in a valuation account. Aggregate market valuation adjustments are recorded as part of accumulated other comprehensive income in shareholders' equity, net of deferred income taxes. Reductions in market value considered by management to be other than temporary are reported as a realized loss and a reduction in the cost basis of the security. The adjusted cost basis of investments available-for-sale is determined by specific identification and is used in computing the gain or loss upon sale. The amortization of premiums and accretion of discounts are recognized in interest income using a methodology that approximates a level yield of interest over the estimated remaining period to maturity.

Debt securities held-to-maturity:

Debt securities held-to-maturity are stated at cost, adjusted for amortization of premiums and accretion of discounts computed by a level yield methodology. The Company has the ability and management has the intent to hold designated investment securities to maturity. Reductions in market value considered by management to be other than temporary are reported as a realized loss and a reduction in the cost basis of the security.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Marketable equity securities:

Marketable equity securities are carried at fair value, with changes in fair value recorded within other noninterest income in the consolidated statements of operations. Dividends received on marketable equity securities are included as a separate component of interest income.

Nonmarketable equity securities:

At December 31, 2021 and 2020, nonmarketable equity securities consist of the following:

	<u>2021</u>	<u>2020</u>
Federal Home Loan Bank stock	\$ 778,900	\$ 1,018,300
Community Bankers Bank stock	<u>58,100</u>	<u>58,100</u>
Total	<u>\$ 837,000</u>	<u>\$ 1,076,400</u>

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

Loans receivable:

Loans receivable are stated at their amortized cost basis, net of any charge-offs. Interest income is recognized in the period earned and is computed based upon the unpaid principal balance.

When serious doubt exists as to the collectability of a loan or when a loan becomes contractually 90 days past due as to principal or interest, interest income is discontinued unless the estimated net realizable value of collateral exceeds the principal balance and accrued interest. When interest accruals are discontinued, income earned but not collected is reversed. Loans are removed from nonaccrual status when they become current as to both principal and interest, when concern no longer exists as to the collectability of the principal and interest, and after a sufficient history of satisfactory payment performance has been established.

Loan origination and commitment fees and certain direct loan origination costs are deferred and amortized as an adjustment of the related loan yields. Generally, these amounts are amortized over the contractual life of the related loans or commitments.

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

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Allowance for loan losses:

The allowance for loan losses is management's estimate of losses inherent in the loan portfolio. It is established through a provision for loan losses charged to earnings. Charged-off loans are charged against the allowance when the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

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

The allowance consists of specific and general components. The specific component relates to loans that are classified as impaired. For these loans, an allowance is established when the discounted cash flows, collateral value, or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis through either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral, less estimated costs to sell, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

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

Premises, furniture and equipment:

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

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Other real estate owned:

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

Cash surrender value of life insurance:

Cash surrender value of life insurance represents the cash value of policies on certain current and former officers and directors of the Company.

Residential mortgage loans held for sale:

Loans held for sale represent loans originated or acquired by the Company with the intent to sell. The Company has elected the lower of cost or market in accounting for residential mortgage loans held for sale. These loans are initially recorded and carried at lower of cost or market value, with any subsequent decreases in fair value recognized in mortgage banking income. Loan origination fees are recorded when earned.

The Company issues rate lock commitments to borrowers on prices quoted by secondary market investors. Derivatives related to these commitments are recorded as either assets or liabilities in the balance sheet and are measured at fair value. Changes in the fair value of the derivatives are recorded in mortgage banking income in the consolidated statements of operations.

Mortgage servicing rights:

Mortgage servicing rights ("MSRs") represent the present value of the future net servicing fees from servicing mortgage loans. Servicing assets and servicing liabilities must be initially measured at fair value, if practicable. The Company's servicing assets are initially measured at fair value and are subsequently measured using either the fair value method or the amortization method, depending on the asset class, which has been determined to be vintage (or loan origination) year.

The methodology used to determine the fair value of MSRs is subjective and requires the development of a number of assumptions, including anticipated prepayments of loan principal. Fair value is determined by estimating the present value of the asset's future cash flows utilizing market-based prepayment rates, discount rates and other assumptions validated through comparison to trade information, industry surveys and with the use of independent third party appraisals. Risks inherent in the MSRs' valuation include higher than expected prepayment rates and/or delayed receipt of cash flows. The value of MSRs is significantly affected by mortgage interest rates available in the marketplace, which influence mortgage loan prepayment speeds. In general, during periods of declining interest rates, the value of mortgage servicing rights declines due to increasing prepayments attributable to increased mortgage refinance activity. Conversely, during periods of rising interest rates, the value of servicing rights generally increases due to reduced refinance activity.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Mortgage servicing rights, continued:

MSRs accounted for using the fair value method are carried at fair value with changes in fair value, changes due to paydowns and payoffs of underlying loans, and servicing fees (cost) recorded in mortgage banking income in the consolidated statements of operations.

For MSRs accounted for using the amortization method, the amortization is determined in proportion to, and over the period of, the estimated net servicing income and recorded in mortgage banking income in the consolidated statements of operations. These MSRs are evaluated quarterly for possible impairment. If the impairment evaluation indicates that the carrying amount of the servicing assets exceeds their fair value, the carrying amount is reduced by recording a charge to income in the amount of such excess and establishing a valuation reserve allowance. If impairment is determined to be other-than-temporary, a direct write-off of the carrying amount would be recorded. Beginning in 2020, the Company began accounting for new MSR vintage year classes using the amortization method.

Core deposit intangible:

As a result of a business combination, the Company may recognize an intangible asset representing the estimated value of core deposits assumed. The Company amortizes the intangible assets over their estimated useful lives. Core deposit intangibles are periodically reviewed for reasonableness and are evaluated for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable.

Goodwill:

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in a business combination. Goodwill is not amortized but tested for impairment on an annual basis, or more often, if events or circumstances indicate there may be impairment. Goodwill impairment exists when a reporting unit's carrying value of goodwill exceeds its implied fair value. Authoritative guidance governing the testing of indefinite lived intangible assets for impairment allows the option to first assess Goodwill by utilizing qualitative factors in determining if it is more likely than not that carrying value exceeds fair value. If, through this analysis, it is determined that it is more likely than not that carrying value exceeds fair value, then the next step requires estimation of the fair value of the reporting unit by quantitative assessment. If the fair value of the reporting unit exceeds its carrying value, no further testing is required. An impairment charge is recognized if the carrying value of the reporting unit's goodwill exceeds its implied fair value. The Company has performed the annual impairment analysis as of December 31, 2021 and concluded no impairment exists.

Liabilities for representations and warranties:

The Company is exposed to certain liabilities under representations and warranties made to purchasers of mortgage loans and servicing rights that require indemnification or repurchase of loans. At the time it issues a guarantee, the Company assesses the need to recognize an initial liability for the fair value of obligations assumed under the guarantee.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Liabilities for representations and warranties, continued:

If determined to be necessary based on the nature of the guarantee, the Company will establish a contingency reserve for its liabilities under representations and warranties provided to purchasers of its mortgage loans and servicing rights. This reserve is maintained at a level considered appropriate by management to provide for known and inherent losses. The reserve is based upon a continuing review of past loss experience, estimates and assumptions of risk elements and future economic conditions. Additions to the reserve are recorded in other expenses.

Management's judgment about the adequacy of any reserve is based upon a number of assumptions about future events which it believes to be reasonable but which may or may not be accurate. There is no assurance that increases in the reserve will not be required in future periods. The Company may from time-to-time be required to repurchase mortgage loans previously sold to investors due to loan nonperformance. Based on management's analysis of current representations and guarantees, it was determined that a liability for potential indemnifications to other third-party purchasers was not necessary at December 31, 2021.

Revenue recognition:

In accordance with Topic 606, revenues are recognized when control of promised goods or services is transferred to customers in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods or services. To determine revenue recognition for arrangements that an entity determines are within the scope of Topic 606, the Company performs the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the Company satisfies a performance obligation.

The Company only applies the five-step model to contracts when it is probable that the entity will collect the consideration it is entitled to in exchange for the goods or services it transfers to the customer. At contract inception, once the contract is determined to be within the scope of Topic 606, the Company assesses the goods or services that are promised within each contract, identifies those that contain performance obligations, and assesses whether each promised good or service is distinct. The Company then recognizes as revenue the amount of the transaction price that is allocated to the respective performance obligation when (or as) the performance obligation is satisfied.

Service Charges on Deposit Accounts: The Bank earns fees from its deposit customers for account maintenance, transaction-based and overdraft services. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees on deposit accounts are charged to deposit customers for specific services provided to the customer, such as non-sufficient funds fees, overdraft fees, and wire fees. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Revenue recognition, continued:

Check Card Fee Income: Check card fee income represents fees earned when a debit card issued by the Bank is used. The Bank earns interchange fees from debit cardholder transactions through the Mastercard payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the card. Certain expenses directly associated with the debit card are recorded on a net basis with the fee income.

Gains/Losses on OREO Sales: Gains/losses on the sale of OREO are included in noninterest income and are generally recognized when the performance obligation is complete. This is typically at delivery of control over the property to the buyer at the time of each real estate closing.

Income taxes:

Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled.

As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. In addition, deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Interest and penalties related to income tax matters are recognized in income tax expense.

The Company recognizes the tax benefit from an uncertain tax position only if it is more likely than not the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such positions are then measured based on the largest benefit that has a greater than 50% likelihood of being realized upon settlement.

Advertising expense:

Advertising and public relations costs are generally expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expensed in the period in which the direct mailings are sent. Advertising and public relations costs were \$291,769 and \$245,155 for 2021 and 2020, respectively, and are recorded within marketing expense.

Retirement benefits:

A retirement savings plan is sponsored by the Company and provides retirement benefits to substantially all officers and employees who meet certain age and service requirements. The plan includes a "salary reduction" feature pursuant to Section 401(k) of the Internal Revenue Code. In 2004, the Company converted the 401(k) plan to a 404(c) plan.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Retirement benefits, continued:

The 404(c) plan changes investment alternatives to include the Company's stock. Under the plan and present policies, participants are permitted to make contributions up to 15% of their annual compensation. At its discretion, the Company can make matching contributions up to 6% of the participants' compensation.

The Company charged \$393,702 and \$273,755 to salaries and benefits expense for the retirement savings plan in 2021 and 2020, respectively. In addition, the Company made elective contributions to the employee stock ownership plan during 2021 and 2020 totaling \$103,507 and \$261,056, respectively, which is recorded within salaries and benefits expense.

During 2006, the Board of Directors approved a supplemental retirement plan for the directors and certain officers. These benefits are not qualified under the Internal Revenue Code and they are not funded. For 2021 and 2020, the supplemental retirement expense was \$193,241 and \$182,791. The current accrued but unfunded amount is \$2,401,001 and \$2,222,703 at December 31, 2021 and 2020, respectively. However, certain funding is provided informally and indirectly by bank owned life insurance policies. The cash surrender value of the life insurance policies is recorded as a separate line item in the accompanying consolidated balance sheets at \$18,475,896 and \$18,101,821 at December 31, 2021 and 2020, respectively.

The Company has split-dollar life insurance arrangements with certain of its officers. At December 31, 2021 and 2020, the split-dollar liability relating to these arrangements totaled \$412,277 and \$388,026, respectively. For 2021 and 2020, the Company recognized net expenses of \$24,251 and \$22,826, respectively, related to these arrangements, which are recorded within salaries and benefits expense.

Stock-based compensation:

The Company can issue stock options, restricted stock, restricted stock units, and other stock-based awards to directors, officers and other key employees. The Company accounts for stock compensation in accordance with Accounting Standards Codification ("ASC") Topics 718 and 505. Under those provisions, the Company has adopted a fair value-based method of accounting for employee stock compensation plans, whereby compensation cost is measured at the grant date based on the value of the award and is recognized on a straight-line basis over the service period, which is usually the vesting period, taking into account retirement eligibility. As a result, compensation expense relating to stock-based awards is reflected in net income as part of salaries and benefit expense in the consolidated statements of operations.

Common stock owned by the employee stock ownership plan ("ESOP"):

All shares held by the ESOP are treated as outstanding for purposes of computing earnings per share. Purchases and redemptions of the Company's common stock by the ESOP are at estimated fair value as determined by market price of the shares. Dividends on shares held by the ESOP are charged to retained earnings. At December 31, 2021 and 2020, the ESOP owned 474,708 and 436,354 shares of the Company's common stock with an estimated value of \$4,842,026 and \$3,277,021, respectively. All of these shares were allocated to participants.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Income per common share:

Basic income per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and similar share-based compensation instruments and are determined using the treasury stock method (see Note 20).

Statements of cash flows:

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

Off-balance sheet financial instruments:

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

Comprehensive income:

The Company reports comprehensive income in accordance with ASC 220, "Comprehensive Income." The standard requires that all items that are required to be reported under accounting standards as comprehensive income be reported in a financial statement that is displayed with the same prominence as other consolidated financial statements. The disclosure requirements have been included in the Company's consolidated statements of comprehensive income.

Business combinations and method of accounting for loans acquired:

The Company accounts for its acquisitions under Financial Accounting Standards Board ("FASB") ASC Topic 805, "Business Combinations," which requires the use of the acquisition method of accounting. All identifiable assets acquired, including loans, are recorded at fair value. No allowance for loan losses related to acquired loans is recorded on the acquisition date because the fair value of the loans acquired incorporates assumptions regarding credit risk. Loans acquired are recorded at fair value in accordance with the fair value methodology prescribed in FASB ASC Topic 820, "Fair Value Measurements and Disclosures."

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Business combinations and method of accounting for loans acquired, continued:

Purchased credit-impaired (“PCI”) loans are accounted for under the accounting guidance for loans and debt securities acquired with deteriorated credit quality, found in FASB Accounting Standards Codification Topic 310-30, “Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality,” formerly American Institute of Certified Public Accountants (“AICPA”) Statement of Position (“SOP”) 03-3, “Accounting for Certain Loans or Debt Securities Acquired in a Transfer,” and initially measured at fair value, which includes estimated future credit losses expected to be incurred over the life of the loans. Loans acquired in business combinations with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered to be PCI loans. Evidence of credit quality deterioration as of purchase dates may include information such as past-due and nonaccrual status, borrower credit scores and recent loan to value percentages. The Company considers expected prepayments and estimates the amount and timing of expected principal, interest and other cash flows for each loan or pool of loans meeting the criteria above, and determines the excess of the loan’s scheduled contractual principal and contractual interest payments over all cash flows expected to be collected at acquisition as an amount that should not be accreted (nonaccretable difference). The remaining amount, representing the excess of the loan’s or pool’s cash flows expected to be collected over the fair value for the loan or pool of loans, is accreted into interest income over the remaining life of the loan or pool (accretable difference). Subsequent to the acquisition date, increases in cash flows expected to be received in excess of the Company’s initial estimates are reclassified from nonaccretable difference to accretable difference and are accreted into interest income on a level-yield basis over the remaining life of the loan. Decreases in cash flows expected to be collected are recognized as impairment through the provision for loan losses. Acquired non-PCI loans are recorded at their initial fair value and adjusted for subsequent advances, pay downs, amortization or accretion of any premium or discount on purchase, charge-offs and additional provisioning that may be required.

Recently issued accounting pronouncements:

The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and/or disclosure of financial information by the Company.

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2022. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company will apply the amendments to the Accounting Standards Update (“ASU”) through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. The Company is evaluating the impact of the ASU on the consolidated financial statements. In addition to the allowance for loan losses, the Company will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio’s composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 1. Summary of Significant Accounting Policies, Continued

Recently issued accounting pronouncements, continued:

In November 2018, the FASB issued guidance to amend the Financial Instruments—Credit Losses topic of the Accounting Standards Codification. The guidance aligns the implementation date of the topic for annual financial statements of nonpublic companies with the implementation date for their interim financial statements. The guidance also clarifies that receivables arising from operating leases are not within the scope of the topic, but rather, should be accounted for in accordance with the leases topic. The amendments will be effective for the Company for reporting periods beginning after December 15, 2022. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company is currently in the process of evaluating the impact of adoption of this guidance on the financial statements.

In March 2020, the FASB issued guidance to provide temporary optional guidance to ease the potential burden in accounting for reference rate reform. The amendments are effective as of March 12, 2020 through December 31, 2022. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2020, the FASB issued guidance to improve financial reporting associated with accounting for convertible instruments and contracts in an entity's own equity. The amendments are effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The Company does not expect these amendments to have a material effect on its financial statements.

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

Risks and uncertainties:

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

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

Reclassifications:

Certain captions and amounts in the 2020 consolidated financial statements were reclassified to conform with the 2021 presentation. The reclassifications did not have an impact on net income or shareholders' equity.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 2. Cash and Due From Banks

The Company is periodically required to maintain balances with the Federal Reserve computed as a percentage of deposits. At December 31, 2021 and 2020, the Company was not required to maintain a reserve balance.

Note 3. Investment Securities

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

	Amortized	Gross Unrealized		Fair Value
	Cost	Gains	Losses	
December 31, 2021				
U.S. Treasury securities	\$ 6,848,607	\$ -	\$ 13,152	\$ 6,835,455
U.S. agency securities	7,630,674	391,861	-	8,022,535
Municipal securities	19,202,487	242,380	155,592	19,289,275
Mortgage-backed securities	45,780,200	221,794	922,289	45,079,705
Corporate bonds	2,500,000	54,960	2,670	2,552,290
Total	<u>\$ 81,961,968</u>	<u>\$ 910,995</u>	<u>\$ 1,093,703</u>	<u>\$ 81,779,260</u>

	Amortized	Gross Unrealized		Fair Value
	Cost	Gains	Losses	
December 31, 2020				
U.S. agency securities	\$ 9,408,643	\$ 699,349	\$ -	\$ 10,107,992
Municipal securities	3,949,076	265,386	-	4,214,462
Mortgage-backed securities	15,869,711	554,839	-	16,424,550
Corporate bonds	2,000,000	18,757	35,867	1,982,890
Total	<u>\$ 31,227,430</u>	<u>\$ 1,538,331</u>	<u>\$ 35,867</u>	<u>\$ 32,729,894</u>

At December 31, 2021 and 2020, the Company had marketable equity securities totaling \$137,859 and \$29,424, respectively.

During the year ended December 31, 2020, the Company transferred all securities classified as held-to-maturity to its available-for-sale portfolio. At the date of the transfer, these securities had a book value of \$8,723,537.

The Company did not have any securities classified as held-to-maturity at December 31, 2021 and 2020.

The following is a summary of maturities of securities available-for-sale as of December 31, 2021. The amortized cost and fair values are based on the contractual maturity dates. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalty. Mortgage-backed securities are presented as a separate line as paydowns are expected to occur before contractual maturity dates.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 3. Investment Securities, Continued

	Debt Securities	
	Available-for-Sale	
	Amortized	
	Cost	Fair Value
Due after one year but within five years	\$ 7,108,845	\$ 7,099,153
Due after five years through ten years	17,659,098	17,637,266
Due after ten years	<u>11,413,825</u>	<u>11,963,136</u>
	36,181,768	36,699,555
Mortgage-backed securities	<u>45,780,200</u>	<u>45,079,705</u>
Total	<u>\$ 81,961,968</u>	<u>\$ 81,779,260</u>

The following tables show gross unrealized losses and fair value of securities available-for-sale, aggregated by investment category, and length of time that individual securities have been in a continuous realized loss position at December 31, 2021 and 2020.

	December 31, 2021		December 31, 2020	
	Fair	Unrealized	Fair	Unrealized
	Value	Losses	Value	Losses
Securities Available-for-Sale				
Less Than 12 Months				
U.S. Treasury securities	\$ 6,835,455	\$ 13,152	\$ -	\$ -
Municipal securities	12,347,761	155,592	-	-
Mortgage-backed securities	36,339,369	922,289	-	-
Corporate bonds	<u>497,330</u>	<u>2,670</u>	<u>1,464,133</u>	<u>35,867</u>
Total	<u>56,019,915</u>	<u>1,093,703</u>	<u>1,464,133</u>	<u>35,867</u>

The Company did not have any securities that were in a continuous loss position for longer than 12 months at December 31, 2021 and 2020.

At December 31, 2021, twenty-three securities classified as available-for-sale were in a loss position as detailed in the preceding table. The Company does not intend to sell these securities in the near future and it is more likely than not that the Company will not be required to sell these securities before recovery of their amortized cost. The Company believes that, based on industry analyst reports and credit ratings, the deterioration in value is attributable to changes in market interest rates and, therefore, these losses are not considered other-than-temporary.

During 2021, the Company sold securities with proceeds of \$7,051,719 and gross gains of \$81,176. During 2020, the Company sold securities with proceeds of \$2,700,000 and gross losses of \$211,018. During 2021 and 2020, the Company recognized gains (losses) of \$8,435 and \$(1,471), respectively, within the consolidated statement of operations related to the increase in fair value of marketable equity securities.

At December 31, 2021 and 2020, investment securities with a par value of \$32,667,980 and \$6,533,893 and a fair market value of \$33,347,071 and \$6,886,132, respectively, were pledged as collateral for securities under agreements to repurchase and to secure public deposits.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses

Major classifications of loans receivable are summarized as follows at December 31:

	<u>2021</u>	<u>2020</u>
Real estate loans:		
Construction	\$ 51,224,463	\$ 42,990,804
Residential	146,762,207	122,569,568
Nonresidential	255,046,402	187,067,588
Total real estate loans	453,033,072	352,627,960
Commercial and industrial	60,290,755	57,513,324
Consumer and other	73,121,646	67,826,350
Total loans	<u>\$ 586,445,473</u>	<u>\$ 477,967,634</u>

Loans sold with limited recourse are 1-4 family residential mortgages originated by the Company and sold to various other financial institutions. These loans are sold with the agreement that a loan may be returned to the Company within 90 days of purchase, at any time in the event the Company fails to provide necessary documents related to the mortgages to the buyers, or if the Company makes false representations or warranties to the buyers. Loans sold under these agreements in 2021 and 2020 totaled \$525,215,558 and \$684,164,470, respectively. The Company uses the same credit policies in making loans held for sale as it does for on-balance-sheet instruments. Sales commitments are to sell loans at an agreed upon price and are generally funded within 60 days.

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed into law, which established the Paycheck Protection Program (PPP). Under the program, the Small Business Administration (SBA) will forgive loans, in whole or in part, made by approved lenders to eligible borrowers for paycheck and other permitted purposes in accordance with the requirements of the program. These loans carry a fixed rate of 1.00% and a term of two years, if not forgiven, in whole or in part. The loans are 100% guaranteed by the SBA and as long as the borrower submits its loan forgiveness application within ten months of completion of the covered period, the borrower is not required to make any payments until the forgiveness amount is remitted to the lender by the SBA. Institutions participating in the program received a processing fee ranging from 1% to 5% based on the size of the loan from the SBA.

The Company participated in both the first and second rounds of PPP in order to provide assistance to customers during the pandemic. During 2020, the Company processed 186 loans for a total of \$30.2 million and received SBA lender fee income of \$1.1 million. Recognizing the operational risk and complexity associated with the PPP portfolio, management made the determination that it was in the best interest of both the Company and its borrowers to sell the PPP portfolio and allow an organization with the appropriate servicing infrastructure to service these loans. The Company completed the sale of the PPP portfolio to The Loan Source Inc., together with its servicing partner, ACAP SME LLC, on August 28, 2020. At the time of sale, the Company immediately recognized the gross lender fee of \$1.1 million in loan interest income and a loss on sale of \$453 thousand in other noninterest expense within the consolidated statements of operations. During 2021, the Company participated in the second round of PPP, processing 262 loans for a total of \$20.5 million and receiving SBA lender fee income of \$1.1 million. The Company again elected to sell the PPP portfolio to The Loan Source Inc., which was completed on June 28, 2021. At the time of the sale, the Company recognized a gain on sale of \$326 thousand and recognized all additional unamortized lender fees as an adjustment to loan interest income.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses, Continued

The following is an analysis of the allowance for loan losses by class of loans for the years ended December 31, 2021 and 2020:

	December 31, 2021						
	Total	Real Estate Loans			Total Real Estate Loans	Commercial and Industrial	Consumer and Other
		Construction	Residential	Non-Residential			
Beginning balance	\$ 6,172,977	\$ 491,065	\$ 1,547,634	\$ 2,351,113	\$ 4,389,812	\$ 695,150	\$ 1,088,015
Provisions	302,700	(524,526)	101,089	446,115	22,678	281,312	(1,290)
Recoveries	702,054	579,188	6,234	-	585,422	45,049	71,583
Charge-offs	(138,155)	-	-	-	-	(22,821)	(115,334)
Ending balance	<u>\$ 7,039,576</u>	<u>\$ 545,727</u>	<u>\$ 1,654,957</u>	<u>\$ 2,797,228</u>	<u>\$ 4,997,912</u>	<u>\$ 998,690</u>	<u>\$ 1,042,974</u>

	December 31, 2020						
	Total	Real Estate Loans			Total Real Estate Loans	Commercial and Industrial	Consumer and Other
		Construction	Residential	Non-Residential			
Beginning balance	\$ 3,529,855	\$ 180,858	\$ 696,519	\$ 1,246,014	\$ 2,123,391	\$ 535,448	\$ 871,016
Provisions	2,908,000	199,707	805,839	1,010,600	2,016,146	345,067	546,787
Recoveries	473,426	110,500	75,200	94,499	280,199	142,343	50,884
Charge-offs	(738,304)	-	(29,924)	-	(29,924)	(327,708)	(380,672)
Ending balance	<u>\$ 6,172,977</u>	<u>\$ 491,065</u>	<u>\$ 1,547,634</u>	<u>\$ 2,351,113</u>	<u>\$ 4,389,812</u>	<u>\$ 695,150</u>	<u>\$ 1,088,015</u>

The following is a summary of loans evaluated for impairment individually and collectively, by class, for the years ended December 31, 2021 and 2020:

	December 31, 2021						
	Total	Real Estate Loans			Total Real Estate Loans	Commercial and Industrial	Consumer and Other
		Construction	Residential	Non-Residential			
Allowance							
Evaluated for impairment							
Individually	\$ 375,992	\$ -	\$ 13,506	\$ -	\$ 13,506	\$ 362,456	\$ 30
Collectively	<u>6,663,584</u>	<u>545,727</u>	<u>1,641,451</u>	<u>2,797,228</u>	<u>4,984,406</u>	<u>636,234</u>	<u>1,042,944</u>
Allowance for loan losses	<u>\$ 7,039,576</u>	<u>\$ 545,727</u>	<u>\$ 1,654,957</u>	<u>\$ 2,797,228</u>	<u>\$ 4,997,912</u>	<u>\$ 998,690</u>	<u>\$ 1,042,974</u>
Total Loans							
Evaluated for impairment							
Individually	\$ 12,743,295	\$ 2,848,774	\$ 1,109,570	\$ 2,529,373	\$ 6,487,717	\$ 6,137,270	\$ 118,308
Collectively	<u>573,702,178</u>	<u>48,375,689</u>	<u>145,652,637</u>	<u>252,517,029</u>	<u>446,545,355</u>	<u>54,153,485</u>	<u>73,003,338</u>
Loans receivable	<u>\$ 586,445,473</u>	<u>\$ 51,224,463</u>	<u>\$ 146,762,207</u>	<u>\$ 255,046,402</u>	<u>\$ 453,033,072</u>	<u>\$ 60,290,755</u>	<u>\$ 73,121,646</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses, Continued

	December 31, 2020						
	Total	Real Estate Loans			Total Real Estate Loans	Commercial and Industrial	Consumer and Other
		Construction	Residential	Non-Residential			
Allowance							
Evaluated for impairment							
Individually	\$ 96,485	\$ -	\$ -	\$ -	\$ -	\$ 66,676	\$ 29,809
Collectively	<u>6,076,492</u>	<u>491,065</u>	<u>1,547,634</u>	<u>2,351,113</u>	<u>4,389,812</u>	<u>628,474</u>	<u>1,058,206</u>
Allowance for loan losses	<u>\$ 6,172,977</u>	<u>\$ 491,065</u>	<u>\$ 1,547,634</u>	<u>\$ 2,351,113</u>	<u>\$ 4,389,812</u>	<u>\$ 695,150</u>	<u>\$ 1,088,015</u>
Total Loans							
Evaluated for impairment							
Individually	\$ 15,442,289	\$ 2,958,255	\$ 1,193,719	\$ 1,406,832	\$ 5,558,806	\$ 9,566,582	\$ 316,901
Collectively	<u>462,525,345</u>	<u>40,032,549</u>	<u>121,375,849</u>	<u>185,660,756</u>	<u>347,069,154</u>	<u>47,946,742</u>	<u>67,509,449</u>
Loans receivable	<u>\$ 477,967,634</u>	<u>\$ 42,990,804</u>	<u>\$ 122,569,568</u>	<u>\$ 187,067,588</u>	<u>\$ 352,627,960</u>	<u>\$ 57,513,324</u>	<u>\$ 67,826,350</u>

The following summarizes the Company's impaired loans as of December 31, 2021:

	Recorded Investment	Unpaid Principal	Related Allowance	Average Balance	Interest Income Recognized
With no related allowance recorded:					
Real estate loans					
Construction	\$ 2,848,774	\$ 2,848,774	\$ -	\$ 2,837,382	\$ 150,005
Residential	1,072,583	1,349,113	-	1,113,917	71,638
Nonresidential	<u>2,529,373</u>	<u>2,564,596</u>	-	<u>2,624,785</u>	<u>158,797</u>
Total real estate loans	6,450,730	6,762,483	-	6,576,084	380,440
Commercial and industrial	71,175	71,175	-	80,885	5,875
Consumer and other	<u>115,745</u>	<u>147,700</u>	-	<u>151,590</u>	<u>12,543</u>
Total	<u>\$ 6,637,650</u>	<u>\$ 6,981,358</u>	<u>\$ -</u>	<u>\$ 6,808,559</u>	<u>\$ 398,858</u>
With an allowance recorded:					
Real estate loans					
Residential	<u>\$ 36,987</u>	<u>\$ 36,987</u>	<u>\$ 13,506</u>	<u>\$ 36,987</u>	<u>\$ 2,813</u>
Total real estate loans	36,987	36,987	13,506	36,987	2,813
Commercial and industrial	6,066,095	6,066,095	362,456	6,473,467	545,256
Consumer and other	<u>2,563</u>	<u>5,625</u>	<u>30</u>	<u>4,176</u>	<u>392</u>
Total	<u>\$ 6,105,645</u>	<u>\$ 6,108,707</u>	<u>\$ 375,992</u>	<u>\$ 6,514,630</u>	<u>\$ 548,461</u>
Total					
Real estate loans					
Construction	\$ 2,848,774	\$ 2,848,774	\$ -	\$ 2,837,382	\$ 150,005
Residential	1,109,570	1,386,100	13,506	1,150,904	74,451
Nonresidential	<u>2,529,373</u>	<u>2,564,596</u>	-	<u>2,624,785</u>	<u>158,797</u>
Total real estate loans	6,487,717	6,799,470	13,506	6,613,071	383,253
Commercial and industrial	6,137,270	6,137,270	362,456	6,554,352	551,131
Consumer and other	<u>118,308</u>	<u>153,325</u>	<u>30</u>	<u>155,766</u>	<u>12,935</u>
Total	<u>\$ 12,743,295</u>	<u>\$ 13,090,065</u>	<u>\$ 375,992</u>	<u>\$ 13,323,189</u>	<u>\$ 947,319</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses, Continued

The following summarizes the Company's impaired loans as of December 31, 2020:

	<u>Recorded Investment</u>	<u>Unpaid Principal</u>	<u>Related Allowance</u>	<u>Average Balance</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
Real estate loans					
Construction	\$ 2,958,255	\$ 2,958,255	\$ -	\$ 2,969,253	\$ 155,098
Residential	1,193,719	1,440,907	-	1,226,973	82,092
Nonresidential	<u>1,406,832</u>	<u>1,426,983</u>	-	<u>1,437,667</u>	<u>91,690</u>
Total real estate loans	5,558,806	5,826,145	-	5,633,893	328,880
Commercial and industrial	5,654,707	5,654,707	-	5,494,786	142,007
Consumer and other	<u>196,441</u>	<u>232,577</u>	-	<u>251,497</u>	<u>19,461</u>
Total	<u>\$ 11,409,954</u>	<u>\$ 11,713,429</u>	<u>\$ -</u>	<u>\$ 11,380,176</u>	<u>\$ 490,348</u>
With an allowance recorded:					
Commercial and industrial	\$ 3,911,875	\$ 3,911,875	\$ 66,676	\$ 2,977,750	\$ 55,358
Consumer and other	<u>120,460</u>	<u>159,893</u>	<u>29,809</u>	<u>141,768</u>	<u>11,105</u>
Total	<u>\$ 4,032,335</u>	<u>\$ 4,071,768</u>	<u>\$ 96,485</u>	<u>\$ 3,119,518</u>	<u>\$ 66,463</u>
Total					
Real estate loans					
Construction	\$ 2,958,255	\$ 2,958,255	\$ -	\$ 2,969,253	\$ 155,098
Residential	1,193,719	1,440,907	-	1,226,973	82,092
Nonresidential	<u>1,406,832</u>	<u>1,426,983</u>	-	<u>1,437,667</u>	<u>91,690</u>
Total real estate loans	5,558,806	5,826,145	-	5,633,893	328,880
Commercial and industrial	9,566,582	9,566,582	66,676	8,472,536	197,365
Consumer and other	<u>316,901</u>	<u>392,470</u>	<u>29,809</u>	<u>393,265</u>	<u>30,566</u>
Total	<u>\$ 15,442,289</u>	<u>\$ 15,785,197</u>	<u>\$ 96,485</u>	<u>\$ 14,499,694</u>	<u>\$ 556,811</u>

The following is an aging analysis of the Company's loan portfolio at December 31, 2021:

	<u>30 - 59 Days Past Due</u>	<u>60 - 89 Days Past Due</u>	<u>Greater Than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans Receivable</u>	<u>Past Due > 90 Days and Accruing</u>
Real estate loans							
Construction	\$ -	\$ -	\$ -	\$ -	\$51,224,463	\$ 51,224,463	\$ -
Residential	-	-	491,351	491,351	146,270,856	146,762,207	-
Nonresidential	-	-	-	-	<u>255,046,402</u>	<u>255,046,402</u>	-
Total real estate loans	-	-	491,351	491,351	452,541,721	453,033,072	-
Commercial and industrial	90,268	-	-	90,268	60,200,487	60,290,755	-
Consumer and other	<u>29,272</u>	-	-	<u>29,272</u>	<u>73,092,374</u>	<u>73,121,646</u>	-
Total	<u>\$ 119,540</u>	<u>\$ -</u>	<u>\$ 491,351</u>	<u>\$ 610,891</u>	<u>\$585,834,582</u>	<u>\$ 586,445,473</u>	<u>\$ -</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses, Continued

The following is an aging analysis of the Company's loan portfolio at December 31, 2020:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Past Due > 90 Days and Accruing
Real estate loans							
Construction	\$ -	\$ -	\$ -	\$ -	\$42,990,804	\$ 42,990,804	\$ -
Residential	-	-	452,012	452,012	122,117,556	122,569,568	-
Nonresidential	-	-	-	-	187,067,588	187,067,588	-
Total real estate loans	-	-	452,012	452,012	352,175,948	352,627,960	-
Commercial and industrial	1,310	-	-	1,310	57,512,014	57,513,324	-
Consumer and other	64,675	35,070	-	99,745	67,726,605	67,826,350	-
Total	\$ 65,985	\$ 35,070	\$ 452,012	\$ 553,067	\$477,414,567	\$ 477,967,634	\$ -

The following is an analysis of the Company's nonaccrual loan portfolio recorded at December 31, 2021 and 2020:

	2021	2020
Real estate loans		
Residential	\$ 599,250	\$ 604,028
Nonresidential	225,993	478,311
Total real estate loans	825,243	1,082,339
Consumer and other	106,000	284,474
Total	\$ 931,243	\$ 1,366,813

Troubled Debt Restructurings

The following table summarizes the carrying balance of troubled debt restructurings ("TDRs") as of December 31, 2021 and 2020:

	2021	2020
Performing TDRs	\$ 1,405,232	\$ 1,584,364
Nonperforming TDRs	205,343	269,752
Total	\$ 1,610,575	\$ 1,854,116

Loans classified as TDRs may be removed from this status for disclosure purposes after a specified period of time if the TDR is subsequently restructured, and the newly restructured agreement specifies an interest rate equal to or greater than the rate that the lender was willing to accept at the time of the restructuring for a new loan with comparable risk, the loan is performing in accordance with the terms specified by the restructured agreement, and certain other criteria are met.

There were no TDRs identified during the year ended December 31, 2021. There were no TDRs that were restructured in the previous twelve months which re-defaulted during the year ended December 31, 2021.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses, Continued

The following is an analysis of TDRs identified during 2020:

	For the year ended December 31, 2020		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Real estate loans			
Residential	1	\$ 45,998	\$ 45,998
Consumer and other	3	25,322	25,322
	4	\$ 71,320	\$ 71,320

During the year ended December 31, 2020, the Company modified four loans that were considered to be TDRs. One loan was designated as a TDR due to a rate concession while two loans were designated as TDRs due to reduced monthly payments. The fourth loan was restructured due to borrower's inability to obtain financing elsewhere. There were no TDRs that were restructured in the previous twelve months which re-defaulted during the year ended December 31, 2020.

The CARES Act amended GAAP with respect to the modification of loans to borrowers affected by the COVID-19 pandemic. Among other criteria, this guidance provided that short-term loan modifications made on a good faith basis to borrowers who were current as defined under the CARES Act prior to any relief, are not TDRs. This includes short-term (e.g. six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant. To qualify as an eligible loan under the CARES Act, a loan modification must be 1) related to COVID-19; 2) executed on a loan that was not more than 30 days past due as of December 31, 2019; and 3) executed between March 1, 2020, and the earlier of a) 60 days after the date of termination of the national emergency by the President or b) December 31, 2020. On April 7, 2020, the federal banking regulators issued a revised interagency statement on loan modifications and the reporting for financial institutions working with customers affected by the COVID-19 pandemic (Interagency Statement). The Interagency Statement confirmed that COVID-19 related short-term loan modifications (e.g., payment deferrals of six months or less) provided to borrowers that were current (less than 30 days past due) at the time the relief was granted are not TDR loans. Borrowers that do not meet the criteria in the CARES Act or the Interagency Statement are assessed for TDR loan classification in accordance with the Company's accounting policies. Beginning in March 2020, the Company provided payment accommodations to customers, consisting of payment extensions of up to 60 days to borrowers negatively impacted by COVID-19. During the year ended December 31, 2020, the Company processed principal deferments on approximately 800 loans. These loans had an aggregate remaining loan balance of \$73.4 million as of December 31, 2020. Borrowers who were current prior to relief and not experiencing financial difficulty prior to COVID-19 were determined not to be considered TDRs. Of the loans that received payment accommodations, none remain in deferral as of December 31, 2021.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses, Continued

Credit Quality Indicators

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

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

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

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

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

The following table lists the loan guides used by the Bank as credit quality indicators and the balance in each category at December 31, 2021:

	<u>Real Estate Loans</u>				<u>Total Real Estate Loans</u>	<u>Commercial</u>	<u>Consumer and Other</u>
	<u>Total</u>	<u>Construction</u>	<u>Residential</u>	<u>Non- Residential</u>			
Pass	\$ 570,834,629	\$ 48,375,689	\$ 145,335,932	\$ 251,238,347	\$ 444,949,968	\$ 53,119,585	\$ 72,765,076
Special mention	13,188,805	2,222,622	865,867	2,746,306	5,834,795	7,100,376	253,634
Substandard	2,422,039	626,152	560,408	1,061,749	2,248,309	70,794	102,936
Doubtful	-	-	-	-	-	-	-
Total	<u>\$ 586,445,473</u>	<u>\$ 51,224,463</u>	<u>\$ 146,762,207</u>	<u>\$ 255,046,402</u>	<u>\$ 453,033,072</u>	<u>\$ 60,290,755</u>	<u>\$ 73,121,646</u>

The following table lists the loan guides used by the Bank as credit quality indicators and the balance in each category at December 31, 2020:

	<u>Real Estate Loans</u>				<u>Total Real Estate Loans</u>	<u>Commercial</u>	<u>Consumer and Other</u>
	<u>Total</u>	<u>Construction</u>	<u>Residential</u>	<u>Non- Residential</u>			
Pass	\$ 457,040,770	\$ 40,032,549	\$ 120,977,789	\$ 182,497,975	\$ 343,508,313	\$ 46,423,452	\$ 67,109,005
Special mention	16,636,289	2,371,296	907,703	2,285,824	5,564,823	10,619,298	452,168
Substandard	4,290,575	586,959	684,076	2,283,789	3,554,824	470,574	265,177
Doubtful	-	-	-	-	-	-	-
Total	<u>\$ 477,967,634</u>	<u>\$ 42,990,804</u>	<u>\$ 122,569,568</u>	<u>\$ 187,067,588</u>	<u>\$ 352,627,960</u>	<u>\$ 57,513,324</u>	<u>\$ 67,826,350</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses, Continued

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

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

The following table summarizes the Company's off-balance sheet financial instruments whose contract amounts represent credit risk for the years ended December 31:

	<u>2021</u>	<u>2020</u>
Commitments to extend credit	\$ 100,340,929	\$ 77,324,283
Standby letters of credit	2,224,976	163,321

Acquired Loans:

Loans acquired through acquisitions are recorded at estimated fair value on their purchase date with no carryover of the related allowance for loan losses. Discounts on loans that are not considered impaired at acquisition are recorded as an accretable discount and are accreted into interest income over the terms of the related loans. The remaining balance of acquired non-PCI loans was \$5.4 million and \$9.7 million with remaining accretable yield of \$101 thousand and \$163 thousand at December 31, 2021 and 2020, respectively. For acquired loans that are considered impaired at the time of acquisition (PCI), the difference between the contractually required payments and expected cash flows is recorded as a nonaccretable discount.

The following table presents changes in the carrying value of PCI loans for the years ended December 31, 2021 and 2020:

	<u>2021</u>	<u>2020</u>
Balance at beginning of period	\$ 5,307,572	\$ 9,113,965
Change due to payments received and accretion	(3,226,477)	(3,837,432)
Advances	13,480	31,039
Balance at end of period	<u>\$ 2,094,575</u>	<u>\$ 5,307,572</u>

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Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 4. Loans and Allowance for Loan Losses, Continued

The following table presents changes in the nonaccretable yield for PCI loans for the year ended December 31, 2021 and 2020:

	<u>2021</u>	<u>2020</u>
Balance at beginning of period	\$ 476,947	\$ 491,373
Reclassification to accretable yield	(199,365)	(29,039)
Change due to recoveries (charge-offs)	780	14,613
Balance at end of period	<u>\$ 278,362</u>	<u>\$ 476,947</u>

The following table presents changes in the accretable yield for PCI loans for the year ended December 31, 2021 and 2020:

	<u>2021</u>	<u>2020</u>
Balance at beginning of period	\$ 372,293	\$ 561,088
Reclassification from nonaccretable yield	199,365	29,039
Accretion, net cash basis interest collections	(140,246)	(217,834)
Balance at end of period	<u>\$ 431,412</u>	<u>\$ 372,293</u>

The Company did not include acquired loans within the calculation of allowance for loan losses as of December 31, 2021 and 2020, as the remaining discount was in excess of calculated allowance on those loans.

Note 5. Premises, Furniture and Equipment

Premises, furniture and equipment consisted of the following for the years ended December 31:

	<u>2021</u>	<u>2020</u>
Land	\$ 8,632,700	\$ 6,732,700
Buildings	16,658,305	14,892,869
Leasehold improvements	2,195,783	1,359,978
Furniture and equipment	10,440,335	9,732,384
Construction in progress	<u>831,950</u>	<u>863,228</u>
Total	38,759,073	33,581,159
Less, accumulated depreciation	<u>(15,954,067)</u>	<u>(15,090,611)</u>
Premises and equipment, net	<u>\$ 22,805,006</u>	<u>\$ 18,490,548</u>

Depreciation expense for the years ended December 31, 2021 and 2020 amounted to \$935,042 and \$811,654, respectively.

At December 31, 2021 and 2020, construction in progress consists mainly of architect fees and site work for potential new branches. As of December 31, 2021, there were no material commitments outstanding for the construction or purchase of premises, furniture and equipment.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 6. Other Real Estate Owned

Transactions in other real estate owned for the years ended December 31, 2021 and 2020 are summarized below:

	<u>2021</u>	<u>2020</u>
Beginning balance	\$ 164,295	\$ 347,552
Additions	-	44,722
Sales	-	(227,979)
Write downs	<u>(29,295)</u>	<u>-</u>
Ending balance	<u>\$ 135,000</u>	<u>\$ 164,295</u>

The Company did not sell any other real estate owned during the year ended December 31, 2021. The Company recognized net gains of \$62,027 on the sale of other real estate owned for the year ended December 31, 2020, which is recorded within other noninterest expense.

Note 7. Mortgage Servicing Rights

The Company retains the right to service the residential mortgage loans that it sells to the Federal National Mortgage Association ("FNMA") and Freddie Mac ("FHLMC") and recognizes those rights as an asset on the consolidated balance sheets.

The Company's servicing assets are initially measured at fair value and are subsequently measured using either the fair value method or the amortization method, depending on the asset class, which has been determined to be vintage (or loan origination) year. Vintage year classes prior to 2020 are measured using the fair value method while subsequent vintage year classes are measured using the amortization method. MSR accounts for under the amortization method are subsequently accounted for at lower of cost or fair value, net of accumulated amortization, which is recorded in proportion to, and over the period of, net servicing income. The Company uses derivative contracts to manage the risk associated with changes in the value of the MSR portfolio accounted for under the fair value method (see Note 8). Any changes in fair value during the period for MSRs carried under the fair value method, as well as amortization and impairment of MSRs under the amortization method, are recorded in mortgage banking income in the consolidated statements of operations.

The following table presents the activity for MSRs accounted for using the amortization method for the years ended December 31, 2021 and 2020:

	<u>2021</u>	<u>2020</u>
Balances, beginning of year	\$ 6,357,700	\$ -
Amount capitalized	5,210,500	7,024,346
Amount amortized	<u>(1,887,124)</u>	<u>(666,646)</u>
Balances, end of year	<u>\$ 9,681,076</u>	<u>\$ 6,357,700</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 7. Mortgage Servicing Rights, Continued

The following table presents the activity for MSR's accounted for using the fair value method for the years ended December 31, 2021 and 2020:

	<u>2021</u>	<u>2020</u>
Balances, beginning of year	\$ 5,662,912	\$ 11,022,638
Changes in fair value ⁽¹⁾	996,049	(2,754,902)
Changes in unpaid principal balance ⁽²⁾	<u>(2,282,940)</u>	<u>(2,604,824)</u>
Balances, end of year	<u>\$ 4,376,021</u>	<u>\$ 5,662,912</u>

(1) Represents changes in value primarily due to market driven changes in interest rates and prepayment speeds.

(2) Represents changes in value of the MSR's due to i) passage of time, including the impact from both regularly scheduled loan principal payments and partial paydowns, and ii) loans that paid off fully during the period.

The fair value of MSR's is highly sensitive to changes in assumptions and fair value is determined by estimating the present value of the asset's future cash flows utilizing market-based prepayment rates, discount rates and other assumptions validated through comparison to trade information, industry surveys, and with the use of independent third party appraisals. Changes in prepayment speed assumptions have the most significant impact on the fair value of MSR's. Generally, as interest rates decline, mortgage loan prepayments accelerate due to increased refinance activity, which results in a decrease in the fair value of the MSR's. Measurement of fair value is limited to the conditions existing and the assumptions utilized as of a particular point in time, and those assumptions may not be appropriate if they are applied at a different time.

At December 31, 2021, the aggregate amount of loans serviced by the Company for the benefit of others totaled \$1.4 billion.

The characteristics and sensitivity analysis of the MSR's are included in the following table as of December 31, 2021 and 2020.

	<u>2021</u>	<u>2020</u>
Composition of residential loans serviced for others		
Fixed-rate mortgage loans	100.00%	100.00%
Weighted average expected life	7.1 years	6.5 years
Constant prepayment rate ("CPR")	8.80%	10.30%
Weighted average discount rate	8.53%	8.54%

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 8. Derivatives

The derivative positions of the Company for the years ended December 31, 2021 and 2020 are reported as other assets and liabilities and are as follows:

	2021		2020	
	Fair value	Notional value	Fair value	Notional value
Derivative assets (liabilities):				
Mortgage loan interest rate				
lock commitments	\$ 824,481	\$ 41,946,942	\$ 2,998,327	\$ 75,722,217
Mortgage loan forward				
sales commitments	(7,695)	33,250,000	(391,563)	62,000,000
U.S. Treasury futures				
contracts	21,914	5,500,000	10,406	7,000,000

The Company uses derivatives to reduce interest rate risk incurred as a result of market movements. These derivatives primarily consist of mortgage loan interest rate lock commitments. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or reference interest rate. The Company uses derivatives primarily to minimize interest rate risk related to its pipeline of loan interest rate lock commitments issued on residential mortgage loans in the process of origination for sale or loans held for sale. The Company also uses U.S. Treasury futures contracts to minimize interest rate risk associated with mortgage servicing rights. The Company's derivative positions are classified as trading assets and liabilities, and as such, the changes in the fair market value of the derivative positions are recognized in the consolidated statements of operations within mortgage banking income.

Note 9. Core Deposit Intangible

The following table presents information about our intangible assets as of December 31:

	2021		2020	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Core deposit intangibles	\$ 880,000	\$ 635,526	\$ 880,000	\$ 513,546

Based on the core deposit intangibles as of December 31, 2021, the following table presents the aggregate amortization expense for each of the succeeding years ending December 31:

	Amount
2022	\$ 97,379
2023	72,778
2024	48,177
2025	23,576
2026 and thereafter	2,564
Total	\$ 244,474

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 9. Core Deposit Intangible, Continued

Amortization expense of \$121,980 and \$146,581 related to the core deposit intangibles was recognized in 2021 and 2020, respectively, and was recorded within other noninterest expense.

Note 10. Deposits

At December 31, 2021, the scheduled maturities of time deposits were as follows:

Maturing In:	<u>Amount</u>
2022	\$ 102,642,119
2023	4,888,966
2024	1,685,262
2025	5,507,430
2026	11,203,602
Total	<u>\$ 125,927,379</u>

Included in total time deposits at December 31, 2021 and 2020, respectively, were brokered time deposits of \$15,398,000 and \$10,021,000. Interest expense on time deposits that meet or exceed the FDIC insurance limit of \$250,000 was \$277,507 and \$741,136 for the years ended December 31, 2021 and 2020, respectively.

Note 11. Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase generally mature on a one to thirty day basis. Under the terms of the repurchase agreement, the Company sells an interest in securities issued by United States Government agencies and agrees to repurchase the same securities the following business day. Information concerning securities sold under agreements to repurchase is summarized as follows at December 31:

	<u>2021</u>	<u>2020</u>
Balance at December 31	\$ 11,372,325	\$ 5,522,872
Maximum month-end balance during the year	11,372,325	15,104,284
Average balance during the year	7,738,616	6,262,461
Average interest rate at the end of the year	0.14%	0.15%
Average interest rate during the year	0.14%	0.19%

At December 31, 2021 and 2020, investment securities with a par value of \$12,353,259 and \$6,533,893 and a fair market value of \$12,873,989 and \$6,886,132, respectively, were pledged as collateral for the underlying agreements.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 12. Federal Home Loan Bank Advances

Federal Home Loan Bank advances consisted of the following at December 31:

	<u>Interest Rate</u>	<u>2021</u>	<u>2020</u>
Fixed rate			
September 20, 2029	1.62%	<u>\$ 10,000,000</u>	<u>\$ 10,000,000</u>
		<u>\$ 10,000,000</u>	<u>\$ 10,000,000</u>

At December 31, 2021 and 2020, the Company has pledged certain loans totaling \$192,090,005 and \$188,432,001, respectively, as collateral to secure its borrowings from the FHLB. Additionally, the Company's FHLB stock is pledged to secure the borrowings.

Note 13. Junior Subordinated Debentures

On June 30, 2005, the Trust (a non-consolidated subsidiary) issued \$10,000,000 in trust preferred securities (callable without penalty) with a maturity of November 23, 2035. Interest on these securities is payable quarterly at three-month LIBOR ("London Interbank Offered Rate") plus 1.83%. In accordance with generally accepted accounting principles, the Trust has not been consolidated in these financial statements. The Company received from the trust the \$10,000,000 proceeds from the issuance of the securities and the \$310,000 initial proceeds from the capital investment in the Trust, and accordingly has shown the funds due to the trust as \$10,310,000 junior subordinated debentures. Current regulations allow the entire amount of junior subordinated debentures to be included in the calculation of regulatory capital. As of December 31, 2021 and 2020, the Company had accrued and unpaid interest totaling \$22,300 and \$22,806, respectively.

Note 14. Borrowings

On August 5, 2016, the Company entered into subordinated debt agreements with eight financial institutions totaling \$5,000,000. The debt initially bore interest at a fixed rate of 7.00% per annum until August 5, 2021 and then variable at three-month LIBOR plus 5.86%, payable quarterly with principal and unpaid interest due at maturity, August 5, 2026. On August 5, 2021, the Company redeemed all \$5,000,000 of these subordinated notes, including any accrued but unpaid interest.

On June 2, 2020, the Company entered into subordinated debt agreements with eight financial institutions totaling \$5,500,000. The debt initially bears interest at a fixed rate of 5.875% per annum until June 1, 2025 and then variable at three-month SOFR ("Secured Overnight Financing Rate") plus 5.51%, payable quarterly with principal and unpaid interest due at maturity, June 1, 2030.

On September 22, 2021, the Company entered into subordinated debt agreements with eleven financial institutions totaling \$10,000,000. The debt initially bears interest at a fixed rate of 3.375% per annum until October 1, 2026 and then variable at three-month SOFR plus 2.45%, payable quarterly with principal and unpaid interest due at maturity, October 1, 2031. The Company recorded \$158,732 in debt issuance costs associated with the subordinated debt, which is recorded net within subordinated debentures and will be amortized over five years. At December 31, 2021, remaining debt issuance costs to be amortized totaled \$150,795.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

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Note 15. Shareholders' Equity

Common Stock - The following is a summary of the changes in common stock outstanding for the years ended December 31, 2021 and 2020.

	<u>2021</u>	<u>2020</u>
Common shares outstanding at beginning of the period	8,329,732	8,260,487
Conversion of Series D preferred stock to common stock	1,200	1,300
Purchase of treasury stock	(300,374)	(50,733)
Restricted stock issued	260,401	148,000
Additional shares granted	34,477	42,178
Forfeiture of restricted shares	(67,026)	(71,500)
Common shares outstanding at end of the period	<u>8,258,410</u>	<u>8,329,732</u>

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

The Company's Series D Preferred Stock ("Series D Shares") is a fixed rate non-cumulative perpetual preferred stock, created July 16, 2015, with the authorized issuance of 70,000 shares. The Series D shares were created for the purpose of converting Common Stock holders with 200 shares or less to Series D Shares. The Series D Shares have no voting rights, and in the event dividends are declared on Common Stock, will be entitled to 4% more than those paid on the Common Stock. Series D Shares will, with respect to ranking to include but not limited to dividends and rights upon liquidation, be senior to all Common Stock.

On September 22, 2017, the Company issued 410,499 shares of Series E Preferred Stock ("Series E Shares"). The Series E Shares were created in conjunction with the Company's 2017 common stock issuance. The Series E Shares have no voting rights, and are entitled to receive dividends as declared in the same per share amount as common stock. During 2018, the Series E Shares were converted to 410,499 shares of non-voting common stock. During 2021, the 410,499 shares of non-voting common stock were converted into voting shares of common stock.

Restrictions on Shareholders' Equity - South Carolina banking regulations restrict the amount of dividends that can be paid to shareholders. All of the Bank's dividends to the Company are payable only from the undivided profits of the Bank. At December 31, 2021, the Bank had undivided profits of \$32,831,807. The Bank is authorized to dividend 100% of net income in any calendar year without obtaining the prior approval of the South Carolina Commissioner of Banks provided that the Bank received a composite CAMELS rating of one or two at the last Federal or State regulatory examination. Under Federal Reserve regulations, the amounts of loans or advances from the Bank to the parent company are also restricted.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 16. Income Taxes

Income tax provision for the years ended December 31, 2021 and 2020 is summarized as follows:

	<u>2021</u>	<u>2020</u>
Provision		
Current income tax expense		
Federal	\$ 1,316,786	\$ -
State	<u>70,049</u>	<u>426,940</u>
Total current	<u>1,386,835</u>	<u>426,940</u>
Deferred income tax expense (benefit)		
Federal	(255,927)	2,851,747
State	<u>(84,003)</u>	<u>(70,525)</u>
Total deferred	<u>(339,930)</u>	<u>2,781,222</u>
Change in valuation allowance	<u>84,003</u>	<u>70,525</u>
Total income tax expense	<u>\$ 1,130,908</u>	<u>\$ 3,278,687</u>

The components of deferred tax assets and deferred tax liabilities as of December 31, are as follows:

	<u>2021</u>	<u>2020</u>
Deferred tax assets:		
Allowance for loan losses	\$ 1,334,083	\$ 1,151,938
Accumulated depreciation	-	15,373
Net operating losses	3,905,592	5,456,175
Non-accrual interest	17,783	14,183
Deferred compensation	708,005	714,532
Purchase accounting on acquisition	112,122	130,976
Leases	30,960	15,336
Unrealized losses on securities available-for-sale	45,679	-
Other	<u>139,232</u>	<u>185,633</u>
Gross deferred tax assets	6,293,456	7,684,146
Less, valuation allowance	<u>(781,483)</u>	<u>(697,480)</u>
Net deferred tax assets	<u>5,511,973</u>	<u>6,986,666</u>
Deferred tax liabilities:		
Prepaid expenses	19,552	19,552
Unrealized gains on securities available-for-sale	-	374,603
Accumulated depreciation	21,379	-
Mark to market adjustments	1,095,721	3,071,748
Deferred loan origination costs	<u>247,107</u>	<u>68,758</u>
Total gross deferred tax liabilities	<u>1,383,759</u>	<u>3,534,661</u>
Net deferred tax assets recognized	<u>\$ 4,128,214</u>	<u>\$ 3,452,005</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 16. Income Taxes, Continued

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the net deferred tax assets to net realizable value. As of December 31, 2021, management has determined that it is more likely than not that the majority of the deferred tax asset from continuing operations will be realized. In 2021, the balance in the valuation allowance changed by \$84,003. The remaining valuation allowance relates to the parent company's state operating loss carryforwards for which realizability is uncertain.

The Company has federal net operating losses of \$14,980,339 and \$22,855,995 for the years ended December 31, 2021 and 2020, respectively. Net operating losses of \$3,981,435 expire at various times from 2029-2037, with the remainder having no expiration date. The Company's ability to benefit from the use of net operating loss carryforwards of \$14,980,339 is limited annually under Section 382 of the Internal Revenue Code. The Company has state net operating losses of \$19,233,440 and \$16,618,136 for the years ended December 31, 2021 and 2020, respectively. State net operating losses of \$9,511,571 expire at various times from 2022-2037, with the remainder having no expiration date.

A reconciliation between the income tax expense and the amount computed by applying the federal statutory rate of 21% to income before income taxes for the years ended December 31, 2021 and 2020 follows:

	<u>2021</u>	<u>2020</u>
Tax expense at statutory rate	\$ 1,345,606	\$ 2,917,916
State income tax expense (benefit), net of federal income tax benefit	(11,024)	281,568
Tax-exempt interest income	(28,559)	(28,420)
Disallowed interest expense	597	1,831
Life insurance surrender value	(78,556)	(85,982)
Excess tax benefit of stock-based compensation	(239,865)	-
Change in valuation allowance	84,003	70,525
Other, net	58,706	121,249
Total	<u>\$ 1,130,908</u>	<u>\$ 3,278,687</u>

The Company had analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions. Tax returns for 2018 and subsequent years are subject to review by taxing authorities.

Note 17. Related Party Transactions

Certain parties (principally certain directors and executive officers of the Company, their immediate families and business interests) are loan customers of the Company. In compliance with relevant law and regulations, the Company's related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with persons not related to the lender and do not involve more than the normal risk of collectability. As of December 31, 2021 and 2020, the Company had related party loans totaling \$1,030,108 and \$1,643,783, respectively.

Deposits from directors and executive officers and their related interests totaled \$7,289,077 and \$2,778,595 at December 31, 2021 and 2020, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

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Note 18. Commitments and Contingencies

In the ordinary course of business, the Company may, from time to time, become a party to legal claims and disputes. At December 31, 2021, management and legal counsel are not aware of any pending or threatened litigation or unasserted claims or assessments that could result in losses, if any, that would be material to the consolidated financial statements.

Effective January 1, 2019, the Company adopted ASC 842 "Leases". Currently, the Company has operating leases on nine of its facilities that are accounted for under this standard. At December 31, 2021 the Company had an operating lease right of use asset of \$6,634,220 and operating lease liability of \$6,781,650.

Rental expense under the leases for the years ended December 31, 2021 and 2020 was \$1,018,203 and \$1,038,459, respectively, and was recorded within occupancy and equipment expense in the consolidated statements of operations.

The weighted average remaining lease term as of December 31, 2021 is 11.1 years and the weighted average discount rate used is 2.85%. The following table shows future undiscounted lease payments for operating leases with initial terms of one year or more as of December 31, 2021:

2022	\$	836,705
2023		797,739
2024		787,965
2025		747,704
2026		674,042
Thereafter		<u>3,921,045</u>
Total undiscounted lease payments		7,765,200
Less effect of discounting		<u>(983,550)</u>
Present value of estimate lease payments (lease liability)	\$	<u>6,781,650</u>

Note 19. Equity Incentive Plan

During 2021, shareholders of the Company approved the 2021 Equity Incentive Plan (the "2021 Plan") under which an aggregate of 600,000 shares of common stock have been reserved for issuance as stock-based awards, including stock options, restricted stock, restricted stock units, and other stock-based awards. The maximum aggregate shares subject to options is restricted to 80,000 in any calendar year to any one participant. Options may be granted for a term of up to ten years from the effective date of the grant. The aggregate number of shares subject to awards of restricted stock and other stock-based awards is restricted to 50,000 in any calendar year to any one participant. At the time of adoption of the 2021 Plan, the Company sunset two equity incentive pools, the 2017 Equity Incentive Plan (the "2017 Plan") and a Restricted Stock Reserve. The 2021 Plan, the 2017 Plan, and the Restricted Stock Reserve are referred to collectively as the "Plans." At December 31, 2021, there were 586,500 shares available for grant under the 2021 Plan and no shares available for grant under the 2017 Plan or Restricted Stock Reserve.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 19. Equity Incentive Plan, Continued

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

Restricted shares may be subject to one or more employment, performance, or other conditions established at the time of grant. Under the terms of the Plans, the restricted shares will vest completely based on the individual grant's vesting period, which is between three and ten years. The shares are forfeited entirely if the participant terminates employment for any reason other than changes in control or death or disability. Any shares of restricted stock that are forfeited will again become available for issuance under the Plans. An employee or director has the right to vote the shares of restricted stock after grant until they are forfeited. Compensation cost for restricted stock is equal to the market value of the shares at the date of the award and is amortized to compensation expense over the vesting period. Dividends, if any, will be paid on awarded but unvested stock.

Nonvested restricted stock for the years ended December 31, 2021 and 2020 is summarized in the following table.

	<u>2021</u>		<u>2020</u>	
	<u>Shares</u>	<u>Weighted-Average Grant-Date Fair Value</u>	<u>Shares</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Nonvested at January 1	423,014	\$ 5.24	358,176	\$ 5.06
Granted	260,401	7.88	148,000	6.15
Vested	(162,670)	2.77	(11,662)	6.60
Forfeited	<u>(67,026)</u>	<u>7.16</u>	<u>(71,500)</u>	<u>6.01</u>
Nonvested at December 31	<u>453,719</u>	<u>\$ 7.36</u>	<u>423,014</u>	<u>5.24</u>

The vesting schedule for these shares as of December 31, 2021 is as follows:

	<u>Shares</u>
2022	\$ 25,293
2023	32,304
2024	52,622
2025	29,500
2026 and thereafter	314,000
Total	<u>\$ 453,719</u>

The Company recognized stock-based compensation costs related to restricted stock of \$483,835 and \$353,396 for the years ended December 31, 2021 and 2020, respectively. As of December 31, 2021, there was \$2,596,857 of total unrecognized compensation cost related to the nonvested restricted stock that will be recognized over the remainder of their vesting schedule.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 19. Equity Incentive Plan, Continued

No stock options were granted during the years ended December 31, 2021 and 2020. Activity related to stock options is summarized in the following table.

	<u>Options</u>	<u>Weighted- Average Remaining Life (Years)</u>	<u>Weighted- Average Exercise Price</u>
Outstanding at December 31, 2020	200,000	2.80	\$ 7.27
Granted	-	-	-
Exercised	-	-	-
Forfeited	<u>(30,560)</u>	<u>-</u>	<u>7.29</u>
Outstanding at December 31, 2021	169,440	1.80	7.27
Options exercisable as of December 31, 2021	136,420	1.80	7.27

The Company recognized stock-based compensation costs related to stock options of \$83,071 and \$58,845 for the years ended December 31, 2021 and 2020, respectively. As of December 31, 2021, there was \$78,568 of total unrecognized compensation cost related to the outstanding stock options that will be recognized over the remainder of their vesting schedule.

Note 20. Income Per Common Share

Net income available to common shareholders represents net income adjusted for preferred dividends including dividends declared, accretions of discounts and amortization of premiums on preferred stock issuances and cumulative dividends related to the current dividend period that have not been declared as of period end.

The following is a summary of the income per common share calculations for the years ended December 31, 2021 and 2020.

	<u>2021</u>	<u>2020</u>
Income available to common shareholders		
Net income	\$ 5,276,738	\$ 10,616,150
Preferred stock dividends	<u>-</u>	<u>-</u>
Net income available to common shareholders	<u>\$ 5,276,738</u>	<u>\$ 10,616,150</u>
Basic income per common share:		
Net income available to common shareholders	<u>\$ 5,276,738</u>	<u>\$ 10,616,150</u>
Average common shares outstanding - basic	<u>7,749,029</u>	<u>7,919,406</u>
Basic income per common share	<u>\$ 0.68</u>	<u>\$ 1.34</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 20. Income Per Common Share, Continued

Diluted income per common share:

Net income available to common shareholders	\$ 5,276,738	\$ 10,616,150
Average common shares outstanding - basic	7,749,029	7,919,406
Dilutive potential common shares	<u>393,072</u>	<u>118,195</u>
Average common shares outstanding - diluted	<u>8,142,101</u>	<u>8,037,601</u>
Diluted income per common share	<u>\$ 0.65</u>	<u>\$ 1.32</u>

Note 21. Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum ratios (set forth in the table below) of Tier 1, Common Equity Tier 1 ("CET1"), and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk-weights ranging from 0% to 150%. Tier 1 capital of the Bank consists of common shareholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets, while CET1 is comprised of Tier 1 capital, adjusted for certain regulatory deductions and limitations. Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital.

The Bank is also required to maintain capital at a minimum level based on total assets, which is known as the leverage ratio. The Bank is required to maintain a required minimum leverage ratio of 4%.

Effective March 31, 2015, quantitative measures established by applicable regulatory standards, including the newly implemented Basel III revised capital adequacy standards and relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act"), require the Bank to maintain (i) a minimum ratio of Tier 1 capital to average total assets, after certain adjustments, of 4.00%, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of 6.00%, (iii) a minimum ratio of total-capital to risk-weighted assets of 8.00% and (iv) a minimum ratio of CET1 to risk-weighted assets of 4.50%. A "well-capitalized" institution must generally maintain capital ratios 2% higher than the minimum guidelines.

In order to avoid restrictions on capital distributions or discretionary bonus payments to executives, the Bank is required to maintain a "capital conservation buffer" in addition to its minimum risk-based capital requirements. This buffer is required to consist solely of CET1, but the buffer applies to all three risk-based measurements (CET1, Tier 1 and total capital). The capital conservation buffer began to be phased in incrementally over time, beginning January 1, 2016 at 0.625% and was fully effective on January 1, 2019, consisting of an additional amount of Tier 1 capital equal to 2.5% of risk-weighted assets.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 21. Regulatory Matters, Continued

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements at December 31, 2021 and 2020.

<i>(Dollars in Thousands)</i>	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
December 31, 2021						
The Bank						
Total capital (to risk-weighted assets)	\$ 95,219	14.05%	\$ 54,209	8.00%	\$ 67,761	10.00%
Tier 1 capital (to risk-weighted assets)	88,168	13.01%	40,657	6.00%	54,209	8.00%
Tier 1 capital (to average assets)	88,168	9.66%	36,519	4.00%	45,648	5.00%
Common Equity Tier 1 Capital (to risk-weighted assets)	88,168	13.01%	30,492	4.50%	44,045	6.50%
December 31, 2020						
The Bank						
Total capital (to risk-weighted assets)	\$ 84,859	15.67%	\$ 43,336	8.00%	\$ 54,170	10.00%
Tier 1 capital (to risk-weighted assets)	78,672	14.52%	32,502	6.00%	43,336	8.00%
Tier 1 capital (to average assets)	78,672	10.31%	30,518	4.00%	38,148	5.00%
Common Equity Tier 1 Capital (to risk-weighted assets)	78,672	14.52%	24,376	4.50%	35,210	6.50%

Note 22. Unused Lines of Credit

The Company had available at December 31, 2021 several unsecured lines of credit, which were unused, to purchase up to \$26,500,000 of federal funds. Also, as of December 31, 2021, the Company had the ability to borrow funds from the FHLB of up to \$151,363,514. At that date, \$10,000,000 had been advanced.

Note 23. Fair Value Measurements

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

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

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

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 23. Fair Value Measurements, Continued

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

Fair Value Hierarchy

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

- Level 1** Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2** Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3** Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

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

Securities Available-for-Sale and Marketable Equity Securities - Securities available-for-sale and marketable equity securities are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Mortgage Loans Held for Sale - Mortgage loans held for sale are comprised of loans originated for sale in the ordinary course of business. The fair value of mortgage loans originated for sale in the secondary market is based on purchase commitments or quoted prices for the same or similar loans and are classified as recurring Level 2. There were no loans held for sale requiring fair value adjustments at December 31, 2021 and 2020.

Mortgage Servicing Rights – Fair Value Method - Mortgage servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of mortgage servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow model are those that market participants would use in estimating future net servicing income. Assumptions in the valuation of mortgage servicing rights may include estimated loan repayment rates, the discount rate, servicing costs, and the timing of cash flows, among other factors. The Company measures mortgage servicing rights accounted for using the fair value method as recurring Level 3.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 23. Fair Value Measurements, Continued

Derivatives - The Company's valuation techniques and inputs to internally-developed models depend on the type of derivative and nature of the underlying rate, price or index upon which the derivative's value is based. Key inputs can include yield curves, credit curves, foreign-exchange rates, prepayment rates, volatility measurements and correlation of such inputs. Where model inputs can be observed in a liquid market and the model does not require significant judgment, such derivatives are typically classified as Level 2 of the fair value hierarchy. Examples of derivatives classified as Level 2 include interest rate lock commitments written for the residential mortgage loans that the Company intends to sell. When instruments are traded in less liquid markets and significant inputs are unobservable, such derivatives are classified as Level 3. Additionally, significant judgments are required when classifying financial instruments within the fair value hierarchy, particularly between Level 2 and 3, as is the case for certain derivatives.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis by level within the hierarchy at December 31, 2021 and 2020.

	December 31, 2021			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. Treasury securities	\$ 6,835,455	\$ -	\$ 6,835,455	\$ -
U.S. agency securities	8,022,535	-	8,022,535	-
Municipal securities	19,289,275	-	19,289,275	-
Mortgage-backed securities	45,079,705	-	45,079,705	-
Corporate bonds	2,552,290	-	2,552,290	-
Total available-for-sale securities	<u>81,779,260</u>	<u>-</u>	<u>81,779,260</u>	<u>-</u>
Marketable equity securities	137,859	-	137,859	-
Mortgage servicing rights	4,376,021	-	-	4,376,021
Derivative assets (liabilities):				
Mortgage loan interest rate lock commitments	824,481	-	824,481	-
Mortgage loan forward sales commitments	(7,695)	-	(7,695)	-
U.S. Treasury futures contracts	21,914	-	21,914	-
	<u>\$ 87,131,840</u>	<u>\$ -</u>	<u>\$ 82,755,819</u>	<u>\$ 4,376,021</u>

	December 31, 2020			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. agency securities	\$ 10,107,992	\$ -	\$ 10,107,992	\$ -
Municipal securities	4,214,462	-	4,214,462	-
Mortgage-backed securities	16,424,550	-	16,424,550	-
Corporate bonds	1,982,890	-	1,982,890	-
Total available-for-sale securities	<u>32,729,894</u>	<u>-</u>	<u>32,729,894</u>	<u>-</u>
Marketable equity securities	29,424	-	29,424	-
Mortgage servicing rights	5,662,912	-	-	5,662,912
Derivative assets (liabilities):				
Mortgage loan interest rate lock commitments	2,998,327	-	2,998,327	-
Mortgage loan forward sales commitments	(391,563)	-	(391,563)	-
U.S. Treasury futures contracts	10,406	-	10,406	-
	<u>\$ 41,039,400</u>	<u>\$ -</u>	<u>\$ 35,376,488</u>	<u>\$ 5,662,912</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 23. Fair Value Measurements, Continued

The changes in Level 3 assets measured at fair value on a recurring basis are summarized as follows:

	Mortgage Servicing Rights
Balance, December 31, 2019	\$ 11,022,638
Changes in fair value recognized in earnings ⁽¹⁾	(2,754,902)
Settlements ⁽²⁾	<u>(2,604,824)</u>
Balance, December 31, 2020	5,662,912
Changes in fair value recognized in earnings ⁽¹⁾	996,049
Settlements ⁽²⁾	<u>(2,282,940)</u>
Balance, December 31, 2021	<u>\$ 4,376,021</u>

(1) Represents changes in value primarily due to market driven changes in interest rates and prepayment speeds.

(2) Represents changes in value of the MSRs due to i) passage of time, including the impact from both regularly scheduled loan principal payments and partial paydowns, and ii) loans that paid off fully during the period.

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2021 and December 31, 2020, aggregated by level in the fair value hierarchy within which those measurements fall.

	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2021				
Impaired loans	\$ 12,367,303	\$ -	\$ -	\$ 12,367,303
Other real estate owned	135,000	-	-	135,000
Mortgage servicing rights	<u>9,681,076</u>	-	-	<u>9,681,076</u>
Total	<u>\$ 22,183,379</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 22,183,379</u>
December 31, 2020				
Impaired loans	\$ 15,345,804	\$ -	\$ -	\$ 15,345,804
Other real estate owned	164,295	-	-	164,295
Mortgage servicing rights	<u>6,357,700</u>	-	-	<u>6,357,700</u>
Total	<u>\$ 21,867,799</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 21,867,799</u>

Impaired Loans - Loans that are considered impaired are recorded at fair value on a nonrecurring basis. Once a loan is considered impaired, the fair value is measured using one of several methods, including collateral liquidation value, market value of similar debt or discounted cash flows. Those impaired loans not requiring a specific charge against the allowance represent loans for which the fair value of the expected repayments or collateral meet or exceed the recorded investment in the loan. Loans which are deemed to be impaired are primarily valued on a nonrecurring basis at the fair value of the underlying real estate collateral. Such fair values are obtained using independent appraisals, which the Company considers to be Level 3 inputs.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 23. Fair Value Measurements, Continued

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

Mortgage Servicing Rights – Amortization Method - Mortgage servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of mortgage servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow model are those that market participants would use in estimating future net servicing income. Assumptions in the valuation of mortgage servicing rights may include estimated loan repayment rates, the discount rate, servicing costs, and the timing of cash flows, among other factors. The Company measures mortgage servicing rights accounted for using the amortization method as nonrecurring Level 3.

The Company had no liabilities measured at fair value on a non-recurring basis.

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of December 31, 2021 and December 31, 2020, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value as of December 31, 2021	Valuation Technique	Significant Observable Inputs	Significant Unobservable Inputs
Impaired loans	\$ 12,367,303	Appraisal Value/Comparison Sales	Appraisals and/or sales of comparable properties	Appraisals discounted 5% to 20% for sales commissions and other holding cost
Other real estate owned	\$ 135,000	Appraisal Value/Comparison Sales	Appraisals and/or sales of comparable properties	Appraisals discounted 10% to 20% for sales commissions and other holding cost
Mortgage servicing rights	\$ 14,057,097	Discounted cash flows	Comparable sales	Weighted average discount rate – 9% Constant prepayment rate – 9%

First Reliance Bancshares, Inc. and Subsidiary

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December 31, 2021 and 2020

Note 23. Fair Value Measurements, Continued

	Fair Value as of December 31, 2020	Valuation Technique	Significant Observable Inputs	Significant Unobservable Inputs
Impaired loans	\$ 15,345,804	Appraisal Value/Comparison Sales	Appraisals and/or sales of comparable properties	Appraisals discounted 5% to 20% for sales commissions and other holding cost
Other real estate owned	\$ 164,295	Appraisal Value/Comparison Sales	Appraisals and/or sales of comparable properties	Appraisals discounted 10% to 20% for sales commissions and other holding cost
Mortgage servicing rights	\$ 12,020,612	Discounted cash flows	Comparable sales	Weighted average discount rate – 9% Constant prepayment rate – 10%

Fair Value of Financial Instruments

The following table includes the estimated fair value of the Company's financial assets and financial liabilities. The methodologies for estimating the fair value of financial assets and financial liabilities measured on a recurring and nonrecurring basis are discussed above. The methodologies for estimating the fair value for other financial assets and financial liabilities are discussed below. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data in order to develop the estimates of fair value. Accordingly, the estimates presented below are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation techniques may have a material effect on the estimated fair value amounts at December 31, 2021 and 2020.

	December 31,			
	2021		2020	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash and cash equivalents	\$ 150,123,960	\$ 150,123,960	\$ 98,688,915	\$ 98,688,915
Mortgage loans held for sale	23,844,303	23,844,303	35,641,877	35,641,877
Loans held for investment, net	579,405,897	572,938,680	471,794,657	468,155,351
Nonmarketable equity securities	837,000	837,000	1,076,400	1,076,400
Deposits	780,833,323	780,115,119	594,000,242	594,383,572
Securities sold under agreement to repurchase	11,372,325	11,372,325	5,522,872	5,522,872
Federal Home Loan Bank advances	10,000,000	9,799,455	10,000,000	9,423,420
Subordinated debentures	25,659,205	25,783,835	20,796,998	18,938,086

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 23. Fair Value Measurements, Continued

Cash and cash equivalents

The carrying amount approximates fair value for these instruments.

Loans held for sale

Loans held for sale are carried at the lower of cost or fair value. These loans currently consist of one-to-four family residential real estate loans originated for sale to qualified third parties. Fair value is based upon the contractual price to be received from these third parties, which may be different than cost.

Loans held for investment

Fair values are estimated for portfolios of loans with similar financial characteristics if collateral-dependent. Loans are segregated by type. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect observable market information incorporating the credit, liquidity, yield and other risks inherent in the loan. The estimate of maturity is based upon the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of the current economic and lending conditions.

Fair value for significant non-performing loans is generally based upon recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discounted rates are judgmentally determined using available market information and specific borrower information.

Nonmarketable equity securities

Nonmarketable equity securities are carried at original cost basis, as cost approximates fair value and there is no ready market for such investments.

Deposits

The fair value of deposits with no stated maturity date, such as noninterest-bearing demand deposits, savings and money market and checking accounts, is based on the carrying value. The fair value of time deposits is based upon the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Subordinated debentures

The fair value of subordinated debentures is estimated by using discounted cash flow analyses based on incremental borrowing rates for similar types of instruments.

Federal Home Loan Bank advances

Fair value is estimated based on discounted cash flows using current market rates for borrowing with similar terms.

Other borrowings

The fair value of federal funds purchased and securities under agreements to repurchase approximate the carrying amount because of the short maturity of these borrowings.

First Reliance Bancshares, Inc. and Subsidiary

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December 31, 2021 and 2020

Note 24. First Reliance Bancshares, Inc. (Parent Company Only)

Condensed Balance Sheets

	<u>December 31,</u>	
	<u>2021</u>	<u>2020</u>
Assets		
Cash	\$ 4,496,727	\$ 5,362,054
Investment in banking subsidiary	89,763,094	81,968,412
Marketable equity securities	137,859	29,424
Nonmarketable equity securities	58,100	58,100
Investment in trust	310,000	310,000
Deferred tax asset	2,023,124	2,062,850
Other assets	-	28,069
Total assets	<u>\$ 96,788,904</u>	<u>\$ 89,818,909</u>
Liabilities		
Junior subordinated debentures	\$ 10,310,000	\$ 10,310,000
Subordinated debentures	15,349,205	10,486,998
Accrued salary benefits	233,814	114,482
Accrued interest payable	94,234	179,576
Total liabilities	<u>25,987,253</u>	<u>21,091,056</u>
Shareholders' equity	<u>70,801,651</u>	<u>68,727,853</u>
Total liabilities and shareholders' equity	<u>\$ 96,788,904</u>	<u>\$ 89,818,909</u>

Condensed Statements of Operations

	<u>For the years ended</u>	
	<u>December 31,</u>	
	<u>2021</u>	<u>2020</u>
Income		
Interest income	\$ 6,277	\$ 9,238
Gain (loss) on change in fair value of marketable equity securities	8,435	(1,471)
Total income	<u>14,712</u>	<u>7,767</u>
Expenses		
Interest expense	808,249	814,143
Salaries and employee benefits	356,286	687,948
Equipment expense	8,719	94,741
Other expenses	69,483	271,779
Total expenses	<u>1,242,737</u>	<u>1,868,611</u>
Income before income taxes and equity in undistributed income of banking subsidiary	(1,228,025)	(1,860,844)
Equity in undistributed earnings of banking subsidiary	<u>6,059,573</u>	<u>12,102,052</u>
Net income before income taxes	4,831,548	10,241,208
Income tax benefit	445,190	374,942
Net income	<u>\$ 5,276,738</u>	<u>\$ 10,616,150</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 24. First Reliance Bancshares, Inc. (Parent Company Only), Continued

Condensed Statements of Cash Flows

	For the years ended	
	December 31,	
	2021	2020
Cash flows from operating activities		
Net income	\$ 5,276,738	\$ 10,616,150
Adjustments to reconcile net income to net cash used in operating activities:		
Deferred income taxes, net of allowance	39,726	(374,942)
Net equity in undistributed earnings of banking subsidiary	(6,059,573)	(12,102,052)
Amortization of debt issuance costs	20,939	21,784
(Gain) loss on change in fair value of marketable equity securities	(8,435)	1,471
Stock based compensation expense	83,071	58,845
Decrease in other assets	28,069	101,568
Increase (decrease) in accrued interest payable	(85,342)	1,769
Increase in accrued salary benefits	119,332	9,286
Net cash used in operating activities	<u>(585,475)</u>	<u>(1,666,121)</u>
Cash flows from by investing activities		
Purchase of marketable equity securities	(100,000)	-
Investment in subsidiary	<u>(3,000,000)</u>	<u>-</u>
Net cash used in investing activities	<u>(3,100,000)</u>	<u>-</u>
Cash flows from financing activities		
Issuance of subordinated debentures, net of issuance costs	9,841,268	5,500,000
Redemption of subordinated debentures	(5,000,000)	-
Issuance of common stock	1,803,222	777,042
Increase in nonvested restricted stock	(1,181,798)	(232,734)
Purchase of treasury stock	<u>(2,642,544)</u>	<u>(396,483)</u>
Net cash provided by financing activities	<u>2,820,148</u>	<u>5,647,825</u>
Net increase (decrease) in cash	(865,327)	3,981,704
Cash and cash equivalents, beginning of year	<u>5,362,054</u>	<u>1,380,350</u>
Cash and cash equivalents, ending of year	<u>\$ 4,496,727</u>	<u>\$ 5,362,054</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2021 and 2020

Note 25. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through March 28, 2022, the date the financial statements were available to be issued and no subsequent events occurred requiring accrual or disclosure.



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